

T H E
BROOKINGS
R E V I E W

Spring 1984

Harry Harding on Reform in China:

*"Virtually every institution in the country ...
has undergone thorough reexamination
and extensive change."*

Ed. A. Hewett on the Soviet Economy:

*"Work incentives are eroding —
and with them the growth rate of all output,
including consumer goods."*

Plus:

William E. Brock on International Trade

Andrew S. Carron on Financial Regulation

*Robert Solomon on Deficits
and the Federal Reserve*

Board of Trustees

Robert V. Roosa
Chairman

Andrew Heiskell
Vice Chairman
Chairman, Executive
Committee

Louis W. Cabot
Vice Chairman

Samuel H. Armacost
J. David Barnes
Vincent M. Barnett, Jr.
Barton M. Biggs
Frank T. Cary
A.W. Clausen
William T. Coleman, Jr.
Lloyd N. Cutler
Thomas Donahue
Charles W. Duncan, Jr.

Robert F. Erburu
Hanna H. Gray
Robert D. Haas
Philip M. Hawley
Roy M. Huffington
B.R. Inman
James T. Lynn
Bruce K. MacLaury
Donald F. McHenry
Robert S. McNamara
Arjay Miller
Donald S. Perkins
J. Woodward Redmond
Charles W. Robinson
James D. Robinson III
Ralph S. Saul
Henry B. Schacht
Roger D. Semerad
Gerard C. Smith
Howard R. Swearer

Morris Tanenbaum
Phyllis A. Wallace
James D. Wolfensohn
Charles J. Zwick

Honorary Trustees

Eugene R. Black
Robert D. Calkins
Edward W. Carter
Bruce B. Dayton
Douglas Dillon
George M. Elsey
Huntington Harris
Roger W. Heyns
John E. Lockwood
William McC. Martin, Jr.
Herbert P. Patterson
H. Chapman Rose
Robert Brookings Smith
Sydney Stein, Jr.

THE BROOKINGS INSTITUTION is a private nonprofit organization devoted to research, education, and publication on important issues of domestic and foreign policy. Its principal purpose is to bring knowledge to bear on the current and emerging policy problems facing the American people. Brookings functions as an independent analyst and critic, committed to publishing its research findings for the information of the public. In its educational activities, it works to bridge the gap between scholarship and policy-making, bringing new information and analyses to the attention of decision-makers in the public and private sectors. Its activities are carried out through three research programs (Economic Studies, Governmental Studies, Foreign Policy Studies), an Advanced Study Program, a Social Science Computation Center, and a Publications Program.

The Institution was incorporated in 1927 to merge the Institute for Government Research, founded in 1916 as the first private organization devoted to public policy issues at the national level; the Institute of Economics, established in 1922 to study economic problems; and the Robert Brookings Graduate School of Economics and Government, organized in 1924 as a pioneering experiment in training for public service. The consolidated institution was named in honor of Robert Somers Brookings (1850-1932), a St. Louis businessman whose leadership shaped the earlier organizations.

Brookings receives financial support from philanthropic foundations, corporations, and private individuals; it also draws funding for its activities from endowment income, conference fees, sales of publications, and charges for computer services. In addition, the Institution undertakes some unclassified government contract studies, reserving the right to publish its findings.

A Board of Trustees is responsible for general supervision of the Institution, approval of fields of investigation, and safeguarding of the Institution's independence. The President is the chief administrative officer, responsible for formulating and coordinating policies, recommending projects, and selecting the staff. In recent years the senior fellows and research associates have numbered about fifty men and women with varied backgrounds in the academic world, government, or both.

The officers and staff conduct a continual review of the Institution's fields of interest. Discussions with government officials, members of Congress, business leaders, foundation officers, and other scholars help to identify issues for study. Subjects are selected for study on the basis of their significance and timeliness, the adequacy of information and techniques of investigation, the availability of personnel and funds, and the relationship of the projects to the Institution's objectives. Each Brookings study is offered as a competent scholarly treatment of a subject worthy of public consideration; the Institution itself does not take positions on policy issues.

T H E
BROOKINGS
R E V I E W

Spring 1984, Vol. 2, No. 3

Change in Communist Societies

3 The Transformation of China

Harry Harding

8 Economic Reform in the Soviet Union

Ed. A. Hewett

**12 Banking on Change: The Reorganization
of Financial Regulation**

Andrew S. Carron

22 Budget Deficits and Federal Reserve Policy

Robert Solomon

26 Interview: William E. Brock on International Trade

32 At Brookings

A special Brookings Council meeting on the State of the Union.

34 New Publications

A collection of essays, edited by Ashton B. Carter and David N. Schwartz, on ballistic missile defense. Henry J. Aaron and William B. Schwartz on health care rationing in Britain and its implications for cost containment efforts in the United States.

To receive any of the books listed, please send a check or money order to:

The Brookings Institution
Department R-1
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036

Be sure to include in your payment \$1.50 for postage and handling.

The Brookings Review is published quarterly by the Brookings Institution, 1775 Massachusetts Avenue, N.W., Washington, D.C. 20036. Second-class postage paid at Washington, D.C. Copyright© 1984 by The Brookings Institution. All rights reserved.

President: Bruce K. MacLaury

Executive Vice President:

Roger D. Semerad

Public Affairs Director:

Margaret M. Rhoades

The Brookings Review

Editor: Mark Goldberg

Art Directors: Marc Alain Meadows,
Robert Wiser

Secretary: Katharine Beckman

Staff Assistant: Carol Jane Corner

Second-class postage paid at Washington, D.C.
USPS I.D. No. 14209; Publication No. 551640; ISSN
0745-1253

Postmaster: Change-of-address cards (Form 3579) should be sent to:

The Brookings Institution
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036

Brookings Books

Defense

Ballistic Missile Defense

Ashton B. Carter and David N. Schwartz (Editors)

\$12.95 paper; \$32.95 cloth.

"A superior collection of essays that gives us both rigorous analysis and a whole spectrum of informed opinion."

—McGeorge Bundy, *The New York Times Book Review*

"Fresh, clear, competent . . . The book is a masterpiece."

—*Choice*

NATO's Nuclear Dilemmas

David N. Schwartz

\$10.95 paper; \$28.95 cloth.

"This well-written book serves as a useful reminder of the important antecedents to the present debate on nuclear weapons in Europe."

—*Foreign Affairs*

"This should be a 'basic book' in any serious collection on European politics, foreign policy, and military affairs."

—*Choice*

Alliance Security: NATO and the No-First-Use Question

John D. Steinbruner and Leon V. Sigal (Editors)

\$9.95 paper; \$28.95 cloth.

"It has often been overlooked in the widespread debate over the no-first-use of nuclear weapons that the *Foreign Affairs* article which stimulated it called not for the immediate adoption of such a policy, but for a study of the implementation and the consequences of a new approach. This work is such a study, undertaken by acknowledged American and European experts. It is unlikely to be excelled in quality."

—*Foreign Affairs*

Health

The Painful Prescription: Rationing Hospital Care

Henry J. Aaron and William B. Schwartz

\$8.95 paper; \$22.95 cloth.

"An excellent guide to the hard choices and sacrifices America would have to make if it really wanted to control health care costs."

—*The New York Times Book Review*

Politics and Health Care Organization: HMOs as Federal Policy

Lawrence D. Brown

\$16.95 paper; \$33.95 cloth.

"The complexity and, on occasion, the incomprehensibility of the American health care system are nowhere better shown than in this detailed study."

—*Choice*

"This book may well be considered the definitive analysis of federal efforts to foster the development of health-maintenance organizations."

—*New England Journal of Medicine*

The Transformation of China

Harry Harding

EVER SINCE the death of Mao Zedong in October, 1976—and especially since Deng Xiaoping's rise to preeminence in December of 1978—China has experienced a period of almost unprecedented dynamism. Virtually every institution in the country—from the agricultural communes to the literary establishment, from the universities to the Party, from industrial management to ideology—has undergone thorough re-examination and extensive change. The China of the 1970s has been transformed almost beyond recognition.

Political Reforms

At home, the reforms being undertaken by Deng, Party General Secretary Hu Yaobang, and Premier Zhao Ziyang fall into five broad categories. In the first of these categories—the political sphere—China has witnessed a substantial, albeit still limited, liberalization. In the early 1950s, class labels (“worker,” “landlord,” “intellectual,” and so forth) were assigned to every Chinese on the basis of family background. To these were often added political labels (“rightist,” “counterrevolutionary,” “bad element,” and the like), particularly during the great Maoist political campaigns between 1957 and 1976. These labels, which became a permanent part of a Chinese citizen's dossier, substantially influenced his or her life chances, from access to higher education to treatment in the court system. Today, the political labels have been removed in almost all cases and the class labels made less pejorative, thus “rehabilitating” millions of Chinese who suffered as political pariahs.

There has also been a tendency toward legalization. During the Maoist period, law was scorned as an unnecessary and undesirable constraint on the exercise of the “dictatorship of the proletariat.” The power of courts atrophied, and citizens were subjected to the often arbitrary decisions of Party secretaries and public security officials. Since 1976, there has been the gradual development of a basic criminal and civil code, as well as the promulgation of laws governing the operations of foreign firms in China. Perhaps most important, the current state constitution, adopted in 1982, places the Party within the legal structure of the state, a sharp departure from the Maoist practice of allowing the Party to override all state laws and regulations. That is not to say, by any means, that Chinese citizens enjoy safeguards comparable to those accorded by Western legal systems; there is no presumption of innocence, for example, and legal proceedings are often, by Western standards, perfunctory. But the process of legalization has increased the predictability of day-to-day life in China and reduced the

*Harry Harding is a senior fellow in the Foreign Policy Studies program at Brookings. Before joining Brookings, he had been on the faculty of Stanford University. He is the author of *Organizing China: The Problem of Bureaucracy* and the editor of *China's Foreign Relations in the 1980s* (forthcoming).*

*"Industrial enterprises are
being made responsible for
their own profits and losses."*

arbitrary authority of individual Party and government officials.

China has also undertaken some limited experiments with democratization. The People's Republic remains, to be sure, virtually a one-party state. The power to make major policy decisions, and to set national priorities, is still in the hands of the Chinese Communist Party. But the government has been given greater responsibility for policy implementation and day-to-day decision-making. And recent reforms have given more play to popular representation. For the first time, Chinese citizens can directly elect representatives to legislatures at the county level—although not yet to provincial or national bodies. For the first time, too, the Party nominates—for positions as deputies to county and local assemblies—a slate of candidates for office that contains more names than there are vacancies to be filled, introducing a bit of competitiveness into the electoral process. Above all, legislators have been given significantly more opportunities to question and criticize administrators. None of these reforms makes China into a liberal democratic system, but the People's Republic can be said to be moving gradually in the direction of consultative bureaucracy.

Intellectual Liberalization

Post-Mao China has also been characterized by a significant degree of intellectual and ideological liberalization—although once again within limits. The loosening of political constraints has been particularly evident in literature and the arts. The Chinese stage, restricted in the mid-1970s to a handful of "revolutionary operas" commissioned by Mao's wife, Jiang Qing, now features the revival of both classical Chinese operas and foreign plays. Chinese painters are now freer to depart from earlier principles of "socialist realism" and to return to traditional styles of painting. Chinese writers have been encouraged to criticize the excesses of the Cultural Revolution.

Similarly, Chinese scholars now enjoy greater freedom to debate a wide range of academic issues, including some with policy implications. There have been lively discussions of the place of Confucianism in traditional China, of the proper methods for stimulating agricultural production, of the nature of American poli-

cy toward China before 1949, and of the role of the West in China's development in the late nineteenth century. The debates suggest that while some scholars still stick to rather orthodox positions, others are willing to marshal new evidence to reach more original and stimulating conclusions.

Thus, Deng Xiaoping has encouraged China's intellectuals and artists to "emancipate the mind." But freedom of expression, while much greater than during the Cultural Revolution, is by no means complete. Chinese artists are still discouraged from experimenting with abstract art. Writers have been criticized, and two editors dismissed, for presenting too gloomy a portrait of contemporary China, for depicting the alienation of ordinary citizens from their own society, and for accepting such Western ideas as humanism and existentialism. And discussion of political matters remains limited by the Party's insistence on adherence to four basic principles: the leadership of the Party; the guiding role of Marxism, Leninism, and Maoism; the maintenance of the "people's democratic dictatorship" as China's form of government; and the pursuit of a socialist road to economic development.

Economic Readjustment

A third broad area of reform is one that the Chinese term economic "readjustment." In essence, Deng and his associates have been altering three of the most important economic priorities established in the 1950s, when the Soviet model of development was transplanted to China, and reinforced in the late 1960s and 1970s, during the decade of the Cultural Revolution.

One of these priorities was an emphasis on forced savings and a concomitant restriction on consumption, intended to permit a rapid pace of economic development. This policy of compulsory asceticism was reflected in a ratio of investment to national income that ranged as high as 36 percent. It was also reflected in the fact that workers enjoyed no wage increases at all between 1963 and 1977; average industrial wages actually fell about 20 percent in real terms over that period. The post-Mao years have seen two major wage hikes for urban workers, measures to increase the incomes of the country's 800 million peasants, and a reduction—to about 27 percent—in the ratio of investment to national income.

A related change has affected the role of consumer goods in the overall economy. A policy of higher wages would be meaningless—and probably both economically and politically dangerous—were it not accompanied by an increase in the production of consumer goods so as to absorb the greater purchasing power. Post-Mao China has effected a significant change in sectoral priorities through the setting of lower targets for heavy industry, which manufactures producer goods, and higher rates of investment for light industry, which produces consumer goods. The rise of consumerism is reflected in declining sales of the plain clothing characteristic of the Maoist period and increasing purchases of more fashionable styles, and in the replacement of bicycles, sewing machines, and watches as the most popular consumer goods by such items

as televisions, tape recorders, cameras, and washing machines.

Finally, while still insisting that China should rely principally on its own efforts in modernization, Chinese leaders have significantly modified the earlier Maoist emphasis on national self-reliance and have greatly expanded the volume of China's trade with the rest of the world. The growth rate of foreign trade over the last five years has been twice as great as the growth rate of the economy as a whole. The ratio of exports and imports to gross national product, which was about 3.5 percent in 1970, has now more than quadrupled to about 16 percent. Equally dramatic have been the changes in China's economic relations with the West. As recently as six months after the death of Mao Ze-dong, the Chinese press was still insisting that China would never accept foreign loans, allow foreign investment, import foreign consumer goods, or permit foreigners to "meddle" in the management of its enterprises. All of these restrictions have been substantially relaxed, as the People's Republic has shown an interest in utilizing a wide range of mechanisms for acquiring capital and technology from abroad.

Economic Reform

Fourth, China's post-Mao leadership has also been experimenting with a wide range of reforms of the basic structure of the country's economic system. A few examples can give the flavor of the kinds of changes now under way:

— Under the "household responsibility system," collectively-owned land in the countryside has been assigned, on a long-term basis, to individual peasant families. After fulfilling their contracts to provide specified quantities of agricultural products to the state, those families are free to sell any surplus on the open market at a higher price.

— Industrial enterprises, too, can make greater use of the market in selling their products and acquiring raw materials. Once state planning goals have been met, factories can sell their products directly to consumers or can barter them for other goods in what one scholar has called "quasi-markets."

— Industrial enterprises are being made responsible for their own profits and losses. Money-losing operations have been told to reduce their losses immediately and to expect that the state will eventually terminate all its subsidies. Managers have been warned that if their concerns continue to run in the red, they may lose their jobs and the enterprises themselves may be shut down or amalgamated with other enterprises. On the other hand, operations that make profits are being allowed to retain a greater part of their net income to use for bonuses, benefits, and new investment.

— The state is no longer providing investment capital to industrial enterprises free of charge. At a minimum, enterprises now must pay fees for the use of fixed capital. And, increasingly, investment funds are being made available in the form of bank loans—carrying interest charges and a term of repayment—on the basis of the expected profitability of the investment.



What these various reforms have in common is that they are intended to restructure the economy in the direction of greater economic efficiency and rationality. The state is using financial levers—such as markets, taxes, and loans—to promote modernization and growth. Incentives, both individual and collective, are being employed to spur production. All this stands in sharp contrast to the Maoist period, when the economy was run by administrative directive, according to political criteria, and without regard for material reward.

Organizational Rejuvenation

The last broad area of reform involves the rejuvenation of China's Party and state bureaucracies. While China's administrative apparatus performed reasonably well over the first twenty-five years of the People's Republic, it is ill-suited to the new demands of intensive modernization. For one thing, the lack of a mandatory system of rotation and retirement has allowed officials appointed in the early 1950s to age in office. Many are too feeble to put in a full day's work. For another, most officials, particularly in the Party, were recruited on the basis of their revolutionary credentials or their class background, rather than their technical or administra-

tive competence. Few are college graduates, and the vast majority, especially in more remote areas, have only a primary-school education.

These underlying problems are reinforced by the effects of the Cultural Revolution on the Party and state organizations. A lack of concern with the rules and regulations—parallel to the disinterest in law mentioned earlier—has meant that there is no clear-cut division of labor among administrative agencies or any formal assignment of responsibilities. Chinese officials themselves liken the operation of their bureaucracy to a football game, in which documents and decisions are passed back and forth without necessarily reaching the goal line. Moreover, about half of the Party's forty million members were recruited during the Cultural Revolution, when the criteria for selection emphasized a commitment to radical theories and programs that are no longer in favor.

In light of these problems, Deng Xiaoping and Hu Yaobang have assigned perhaps the greatest priority to the rejuvenation and reform of China's administrative structure. Over the past several years, relatively effective measures have been taken to reduce the size of bureaucratic agencies, more clearly specify their responsibilities, reduce the average age of officials, and increase their levels of education. Veterans of the bureaucracy are being gently placed on "advisory committees" in order to make room for younger, better educated officials. The ambitious goal is to see to it that by 1990 half of China's 21 million cadres will have a college education or its equivalent.

Just now under way is the second prong of organizational reform: a three-year "rectification" of the Party itself. Party members are being asked to study the major programmatic statements of the post-Mao era and to internalize the new commitments to modernization, liberalization, and reform. They are also being asked to stop abusing their offices for the sake of personal privilege for themselves, their families, and their friends. Those that fail to follow these directions—as well as those who are judged to have risen to power solely as a result of the power struggles of the Cultural Revolution—are subject to expulsion from the Party.

The Reforms in Context

Thus, China today is engaged in a program of radical reform every bit as sweeping as in the Maoist period. Indeed, the common desire for dramatic change represents a striking, if paradoxical, similarity between two men often regarded as political adversaries. Like Mao Zedong on the eve of the Cultural Revolution, Deng Xiaoping today is a man in a hurry: an elderly leader, acutely aware of his own mortality, who realizes that he has only a short time left to set China on what he believes to be the proper course. Both Mao and Deng understood, when they began their reforms, that they needed to weave their visions deeply into China's political and social fabric—through the selection of faithful successors, the education of younger generations, and the construction of new political institutions—if they were to ensure the survival of their programs after their deaths.

What is more, both Mao and Deng had to contend with the same set of obstacles: the Leninist political structure, symbolized by the Party bureaucracy, and the Stalinist economic system, dominated by the central planning apparatus and the ministries for heavy industry, that had been built on the Soviet model in the mid-1950s. Both men concluded, at different times and for different reasons, that a fundamental reform of Leninism-Stalinism was the key to the successful development of China.

But Mao and Deng attacked this common enemy from diametrically opposite directions. Mao assaulted Leninism-Stalinism from the left. His utopian vision for China, as reflected in the Cultural Revolution, emphasized continued class struggle against "bourgeois" elements inside and outside the Party; the adoption of policies enshrining the values of populism, egalitarianism, and national self-sufficiency; and the extension of state control and Party doctrine into virtually every area of life.

Deng Xiaoping has attacked Leninism-Stalinism from the other end of the Chinese political spectrum. Deng's vision for China is, in the Chinese context, profoundly liberal. His program emphasizes national unity and economic modernization rather than class struggle. It replaces mass mobilization with organizational rationalization and political institutionalization. It promises a substantial relaxation of controls over intellectual and cultural life and a much more pragmatic approach to social and economic problems. And, compared to Mao, Deng has been willing to tolerate—even encourage—much higher levels of inequality, specialization, hierarchy, and international interdependence.

Problems

Given the sweeping and radical nature of Deng's reforms, it is not surprising that they have encountered serious problems and opposition. One set of complications stems from the technical difficulties inherent in reforming a complex planned economic system, especially one widely agreed to have irrational prices. Attempts to decentralize the economy, allow a greater role for local initiative, and delegate an increasing number of economic decisions to the marketplace have led at various times since 1978 to over-investment, shortages of construction materials, serious state deficits, substantial inflation, and diversion of resources to low-priority (but high-profit) undertakings. Reimposing central control—and thus effectively reversing or delaying the reforms—has seemed a logical response to these difficulties, at least in the short run.

Second, some of the reforms in the political and intellectual areas have had unintended consequences. Since 1978, China has witnessed a growing crisis of confidence among its young people, as Western political ideas and social values have entered the country along with Western capital and technology and as Chinese leaders themselves have acknowledged the need to loosen the strictures of Marxist doctrine. There has been a noticeable decay in social order—as evidenced by increases in corruption, prostitution, pornography, and crime—that can be traced at least in part to the

economic and political liberalization that has been under way.

Partly as a result of these problems, Deng's reforms have encountered serious political opposition. Some, of course, comes from the left, from those who still believe in the virtues of Maoist egalitarianism, populism, and self-sufficiency. Thus far, though, the strength of the left in China is limited. It has suffered greatly from widespread revulsion at the excesses of the Cultural Revolution, as well as from the reshuffling of Party and government personnel that has occurred since 1978. But the strength of the left could revive if the reforms produce inequalities—between coastal and interior regions, between skilled and unskilled workers, between richer and poorer peasants—that come to be regarded as unjust. It could also increase if China is perceived as having sacrificed its political sovereignty and cultural integrity in its quest for foreign capital and technology.

But the principal opposition to Deng's reforms has come from the center of the Chinese political spectrum. It comes from the Party establishment, which is concerned about the declining relevance of ideology and revolutionary leadership in post-Mao China and which fears the rise of dissent and disunity. It comes from important segments of the Army, which share the Party's skepticism about the consequences of political liberalization, fear the effects of economic reform on their ability to attract recruits, and resent the constraints that have been imposed on the military budget in the name of civilian modernization. It comes, too, from the ministries of heavy industry and from the central planning establishment—the bulwarks of economic Stalinism—which see their resources and status threatened by the new emphasis on consumerism and market mechanisms.

Prospects

This combination of technical intractability, unintended consequences, and political opposition makes it difficult to assess the longer-term prospects for Dengist reforms. But here another difference between Mao and Deng becomes relevant. Political scientist Samuel Huntington of Harvard has distinguished between two strategies of political reform: the "blitzkrieg" strategy, in which a comprehensive reform package is laid out all at once and the maximum possible political resources are assembled for its pursuit; and the "Fabian" strategy, which takes a more incremental and fragmented approach to achieving political change.

Mao was a master of the political blitzkrieg. In massive movements such as the Great Leap Forward and the Cultural Revolution, he set forth utopian visions of China's future and mobilized vast numbers of Chinese in intense campaigns to implement them. While Deng Xiaoping's program for the future is every bit as comprehensive and radical as Mao's, his strategy of reform draws much more from the Fabian approach. Deng is skilled at dealing with potential opponents through compromise, cooptation, and preemption.

Thus, time and time again Deng has appeared to compromise with his opponents, only to reintroduce

*"Like Mao Zedong on the eve
of the Cultural Revolution,
Deng Xiaoping today is a man
in a hurry."*

his reforms at a later date. The political dissent expressed on "Democracy Wall" in late 1978 and early 1979 led Deng to define the limits of acceptable political expression, but did not prevent the ongoing programs of democratization and legalization outlined above. Economic problems in 1980—particularly rapidly rising prices and excessive investment—caused a postponement of economic reforms, but the measures were reintroduced as the economy improved. The emergence of crime, corruption, and unorthodox literature more recently led to a brief crackdown on "spiritual pollution" and a revival of Maoist ideology at the end of last year, but the drive was not permitted to spill over into the economic sphere. Complaints that China was becoming too closely aligned with the United States encouraged Chinese leaders to announce a more "independent" foreign policy in 1982, but that did not prevent the consolidation of Sino-American relations during Premier Zhao Ziyang's recent visit to Washington.

In short, Deng's strategy has been one of "bobbing and weaving." He has been astute enough to know when his reforms have encountered serious opposition and skillful enough to know how to preempt or deflect criticism. His own prestige has enabled him to maintain a solid base of support within the central Party establishment and has prevented the coalescence of groups and leaders that form a potential opposition.

But Deng's chosen successors, Hu Yaobang and Zhao Ziyang, certainly lack Deng's standing in the Party and may well lack his political acumen. Thus, the prospects for Deng's reforms after his death or full retirement depend on the ability of the rectification campaign to reduce opposition within the Party establishment and build support for his initiatives, as well as on the effectiveness of the reforms themselves. The inability of Mao to overcome the resistance of Leninism-Stalinism in China and the inability of the Soviet Union to undertake sustained reform suggest a cautious forecast for the future. To be sure, a complete reversal of post-Mao trends, in the direction of the restoration of utopian Maoism, is highly unlikely. But the chances for sustained liberalization, particularly in the political sphere, are no better than ever. Indeed, the ultimate victor in the current struggles in China could well be the Leninist-Stalinist system that both Mao and Deng have attempted to undermine.

Economic Reform in the Soviet Union

Ed. A. Hewett

YURI ANDROPOV made it clear, soon after becoming general secretary of the Soviet Communist Party in November, 1982, that the state of the Soviet economy was one of his major concerns. In his first public statements as general secretary, he painted a fairly frank picture of an economy beset by falling growth rates, widespread shortages of key inputs and most consumer goods, and the slow disappearance—at least among workers for state enterprises—of whatever work ethic had ever existed.

Andropov took two measures to address the underlying causes of this deteriorating economic situation. First, he initiated a wide-ranging debate among Soviet economists on the economic system. That debate, still going on today, has generated a wealth of proposals, from extensive reorganization of the intricate hierarchy that now controls economic activity in the Soviet Union to a virtually complete dismantling of that system in favor of one relying much more on markets than on planners to allocate resources.

Second, he announced in mid-1983, and began on January 1 of this year, an experiment in which selected enterprises in five ministries have been given more autonomy in making decisions and more responsibility for the outcomes of those decisions. This experiment, while interesting, has been rather modest in scope compared to the debate. It is possible that Andropov intended to use the experiment *and* the debate to lay the groundwork for a more ambitious reform program to be introduced in the latter half of the decade.

Andropov's death on February 9 rendered such speculation moot. There is now a new general secretary—Konstantin Chernenko—and, given his advanced age and the state of his health, there may be yet another within several years. The succession to a younger generation of leaders is under way, but it is proceeding very slowly as—funeral by funeral—the old generation is taken out of power. What are the prospects for economic reform in the new situation? What implications might reform have for the Soviet Union's economic performance?

The Problems of the Soviet Economy and the Pressures for Reform

Ed. A. Hewett is a senior fellow in the Foreign Policy Studies program at Brookings. He has taught at the University of Texas and the University of Pennsylvania. He is the author of Energy, Economics, and Foreign Policy in the Soviet Union (forthcoming).

Since the 1930s, economic activity in the Soviet Union has been governed by a multilevel, highly specialized state hierarchy that is in turn controlled *de facto* by the Politburo of the Party's Central Committee. Enterprises are directed by approximately 50 ministries, each of which has responsibility for a segment of the country's output. Production is organized according to

annual plans that are negotiated each year under the immediate supervision of the State Planning Committee (Gosplan) and the general supervision of the Council of Ministers, within guidelines approved by the Politburo. Through these very detailed plans, the bureaucracy seeks to direct all of the important decisions of each enterprise.

This system is designed to assure the Party complete and unquestioned control over the economy, and it has done that fairly well, although not perfectly. But the system is increasingly unable to provide a level of economic performance consistent with what leaders expect—a national income sufficient to provide a politically acceptable supply of consumer goods while also meeting the needs of investors and the defense sector. It is this dissatisfaction with economic performance—which dates back more than a quarter century, but has grown since the mid-1970s—that provides the impetus for economic reform in the Soviet Union.

There are several basic indicators of economic performance that both Brezhnev and Andropov mentioned frequently as sources of concern.

Falling growth rates. National income growth rates—as measured using either official Soviet statistics or Western recalculations—have been on a secular downward trend for almost two decades. As Figure 1 indicates, in the last years of the 1970s the Soviet economy came perilously close to no growth; indeed, if hidden inflation were taken into account, the data might show zero growth.

Macroeconomic imbalances. It is now widely acknowledged in the Soviet Union that personal incomes are growing more rapidly than the supplies of consumer goods. Enterprises consistently meet or exceed the wage payment totals provided for in their annual plans, even when they produce less than the planned levels of output. As a result, work incentives are eroding—and with them the growth rate of all output, including consumer goods.

The investment picture is not much better. Enterprises have a hunger for investment, reflecting both their very secure positions in the economic system—they typically face little competition from domestic sources and none from imports—and the willingness of the state to provide subsidies when performance falls short of projections. Ministries do not seek to reduce this excess demand; on the contrary, they tacitly support it, since higher capital expenditures can increase their own size and influence. Gosplan must try to control this high investment demand, choosing among applications for investment funds without the aid of sensible prices reflecting the judgments of a market—and in an atmosphere of tremendous political pressure, as local party and government organizations lobby hard for projects in their areas. The bureaucracy responds, quite naturally, by authorizing more investment starts than would be prudent given the capacity of the construction industry. As might be expected under the circumstances, construction work on many of these projects progresses very slowly; it is not unusual for the completion of a large project to take between five and ten years.

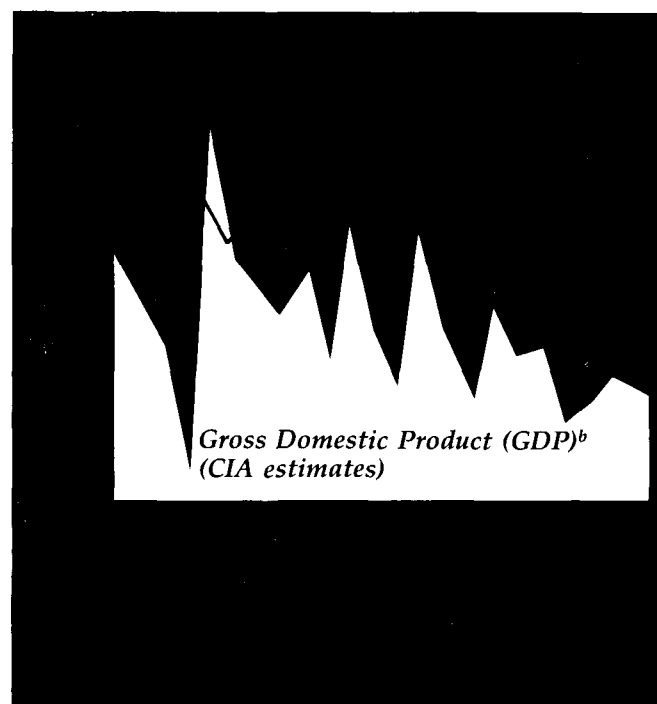
Microeconomic imbalances. Inconsistencies be-

tween supply and demand for individual products have been a more or less constant consequence of Soviet socialism, but they too seem to have worsened in recent years. There are many outmoded, low-quality, and essentially unsalable consumer durables that enterprises continue to produce because by doing so they can earn bonuses with much less effort than would be required to produce the newer sorts of high-quality durables that are in chronic short supply in the Soviet Union. As living standards have risen, consumers have grown more sophisticated, and their willingness to accept substandard products has declined. This is yet another reason for the erosion in the power of material incentives in the Soviet Union.

Producers encounter similar problems as purchasers of capital and other inputs. They frequently find that they cannot buy what they need to maintain or increase the quality of their output; instead, they must accept capital embodying old technologies, material inputs of inadequate average quality, and high variability.

High demands for inputs. It is now common in the Soviet Union to bemoan the tendency of enterprises to squander material and human inputs in attempting to achieve their planned levels of output. There are no external constraints, such as markets, on the willingness of enterprises to accept high costs in their pursuit of output growth. As a result, the Soviet Union is experiencing shortages of electric power and energy, some raw materials and intermediate products (iron ore and steel being good examples), transport capacity, and labor. These shortages in turn lead to production bottlenecks that contribute to low capacity-utilization rates in Soviet factories.

Low rates of technical change. Enterprises' lack of enthusiasm for technical change, in either their products or their production processes, has been a perennial problem in the Soviet Union. Soviet leaders have known that technical change is crucial to the achieve-





Lise Gladstone

ment of high growth rates, and the reform efforts of the last quarter century have been designed to stimulate such change.

These five symptoms of economic ills—and the list could easily be extended—trouble Soviet planners. If anything, the indicators of underlying ailments have all gotten worse since the mid-1970s. Andropov discussed them openly and stated that something had to be done, but in fact he had too little time left to accomplish anything other than starting the debate. It now falls to Chernenko and the other members of the Politburo to act; these problems will not go away otherwise.

Why Economic Performance Is Lagging

Soviet leaders and economists would not take exception to the list of problems set out above. However, they do differ—among themselves, as well as with many Western economists—in their diagnoses of the causes of these difficulties and in their prescriptions for reform. Before turning to a brief discussion of the reform options under consideration in the Soviet Union, it is useful to consider what, from an outsider's point of view, appear to be the three fundamental causes of current economic problems.

Enterprise security. The Soviet system is consciously designed to minimize the competitive pressures on enterprises. Four features of the system are crucial to this end. First, central planners carefully designate individual suppliers for individual buyers. Second, all of the enterprises in an industry are supervised by the same ministry (which has no interest in having them fight among themselves). Third, there is an excess demand for most products; therefore, most markets are dominated by sellers. Finally, it is state policy to minimize imports that would compete with domestic products.

These features considerably reduce the rigors that lead to business failures and reorganizations in Western economies. Soviet enterprises can still fail to earn sufficient funds to cover their costs. When they do, however, their shortfalls are offset by automatic subsidies. There is no such thing as bankruptcy in the Soviet Union—it is not clear what the term would mean under socialism—but obviously incompetent managers can be (and sometimes are) demoted.

Employment security. Because of the excess demand for labor in the Soviet Union (a consequence of ambitious plans from above and enterprise security), the individual worker knows that the enterprise for which he works will be loath to release him—and that if he does lose his job, it will be easy to find another. Furthermore, even in the rare cases in which enterprises are inclined to fire workers—for example, in the Shchekino experiments of the 1970s, which rewarded the participating enterprises for reducing their payrolls—the Party has generally prevented significant layoffs for fear of the potential political repercussions. This extraordinary job security weakens the incentive that workers have to work hard.

Centralization of economic decision-making. Soviet planners send to each enterprise targets that cover in detail all aspects of the enterprise's operations: outputs, inputs, the technologies that connect them, new investment, environmental controls, and so on. Because planners cannot possibly know all they need to know about all enterprises, there are bound to be inconsistencies among the targets that they set. Enterprises must choose, therefore, which targets to accord priority. The key question becomes which targets the planners regard as most important, and the answer—in fact, if not in statute—has always been the same: plans for the growth of output. Ministries are judged by the output of their enterprises, and so they judge enterprises by that criterion. The failure to meet other objectives can be forgiven if production is on target. Ultimately, the only “customers” that count with enterprises are the central authorities that supervise them.

Of the five economic problems discussed above—falling growth rates, macroeconomic imbalances, microeconomic imbalances, high demands for inputs, and weak incentives for technical change—the last four can readily be attributed to the causes just posited; the first of the problems—falling growth rates—is in part a function of other factors.¹ In discussing reform proposals currently under consideration by Soviet leaders or likely to be advanced under Chernenko, it is important to ask how those proposals address the three crucial causes of difficulties in economic performance.

Alternatives Available to Soviet Leaders

Soviet leaders can choose among four options in responding to the continuing deterioration in economic performance. Their alternatives are to do nothing; to change policies without changing the system; to introduce partial reforms; and to introduce a radical reform of the system.

Given the persistence of serious performance problems, it is unlikely that Chernenko will decide to do nothing. If he were nevertheless to follow that path, we should expect the problems slowly to grow worse: Growth rates would continue to fall, imbalances would become more severe, and so on.

A more active, but still conservative, approach would involve changing policies but not the system. There are many possibilities here. Simple personnel changes could have a considerable impact. Planners could tinker with incentive systems, as they have in the past, in an effort to change enterprise behavior without making basic structural changes. Or investment reallocations could increase the priority of consumer goods (possibly at the expense of investment in energy). Measures like these would not threaten the existing system, but would simply seek to improve its performance. Soviet leaders are constantly introducing such policy changes in the hopes of fine-tuning the system. Partial reforms are the third alternative. In this category, too, possibilities are numerous. For example, the existing industrial ministries could be merged into a few high-powered aggregations in order to improve the coordination, and reduce the parochialism, of industry-specific planning. A different sort of streamlining actually was attempted in 1973, when Brezhnev sought to simplify the links between ministries and enterprises by creating "production associations" that would combine enterprises into larger and more efficient units. The common thread in these and other partial reforms attempted or contemplated is the assumption that if a single part of the system is fixed, the functioning of the whole will be much improved.

Radical reforms—the last alternative—assume that only by revamping all parts of the system simultaneously will it be possible to deal effectively with performance problems. Under proposals in this category, central planners would abandon their attempts to control the daily operations of enterprises; the enterprises themselves would decide what to produce and how, from whom to buy inputs, and to whom to sell outputs. Prices—including exchange and interest rates—would be allowed to fluctuate, so that enterprises would have accurate information on the social valuation of their output. The state would continue to provide public goods (such as defense and health care), and it would continue to exert considerable influence over the economic system through the use of taxes, subsidies, and control over capital and foreign exchange markets. Only radical reforms would address the fundamental causes of Soviet economic performance problems—by eliminating the tight central control of economic activity and by forcing both enterprises and workers to worry about their ability to produce products that customers actually want.

The Outlook for the Near Future

There is no way to predict with confidence just how far Soviet leaders will go in pursuing economic reform in the near future (that is, in the remainder of this decade). Soviet officials do not think that their country is in the midst of an economic crisis, and most outside observers would agree with that assessment. However, the ongoing decline in the performance of the Soviet economy is important enough to Soviet leaders that doing nothing will be out of the question. At the very least, they will have to consider some combination of policy changes and partial reforms of the economic system. This is a natural starting point for the leaders, because the changes involved are marginal; the attendant uncertainties are, therefore, small; and it is easy to reverse direction if something does not work.

The search for an effective combination of moderate changes is not necessarily doomed to failure. There are many irrationalities in the Soviet economic system that could be affected by central measures taken within the current system. A concerted effort to bring younger persons into positions of responsibility in the planning hierarchy—and, at the same time, to improve planning and change priorities—might have some impact on economic performance if it were skillfully handled. It is too easy for an outsider impressed with the basic irrationality of a system to dismiss the possibilities insiders can exploit to prolong the life of the system.

Still it is unlikely that dramatic improvements in economic performance will come through policy changes and partial reforms; therefore, the ultimate logic of developments is on the side of a shift towards more radical reforms. However, absent a dramatic further deterioration in economic performance, it is highly improbable that the Soviet leadership will begin seriously to contemplate radical reforms before the end of this decade. So many vested interests in the party and the government would be affected by such reforms, and so much political and economic uncertainty associated with them, that they will be undertaken only if there appears to be no other alternative.

This suggests that in the remainder of the decade, Soviet economic performance will probably continue a very gradual secular decline. That decline will require Soviet leaders to make increasingly difficult decisions among the competing demands of consumers, investors, defense, and other socialist nations. The necessity of such choices will certainly be *one* incentive for the Soviets to work for a reduction in East-West tensions and for a deceleration of the arms race. It is, in part, up to the United States whether there will be other incentives in the same direction.

1. These factors include the natural maturation of the economy, which eliminates some of the possibilities available earlier for rapid growth (for example, shifting underemployed agricultural labor to industry); the rising marginal costs of key material inputs, as Soviet (and world) supplies become more expensive to exploit; and the secular decline in labor force growth rates.

Banking on Change: The Reorganization of Financial Regulation

Andrew S. Carron

INNOVATION and economic adversity drastically changed the character of U.S. financial markets during the past half-dozen years. New types of institutions appeared; long-established types faded from the scene. Traditional distinctions blurred, and old labels became inadequate to describe the new activities. In contrast to the industry, our financial regulatory system remained static. The aggressive, automated, diversified multi-billion dollar companies that compete in today's financial services industry are regulated by agencies designed for the Great Depression, the Panic of 1907, and the Civil War. Regulatory techniques are outmoded and inconsistent. The system is characterized by overlapping authorities, duplicate controls, conflicts, and omissions. It is a disorderly structure, hard-pressed to cope with ongoing changes in the industry.

This situation was not intended, of course. During the Depression, a policy was put into place that emphasized the assurance of stability, the protection of depositors, and the nurturing of socially desirable investments (for example, in housing). Components of financial services were defined, segregated, and separately regulated. The banking, thrift, securities, and insurance industries each were given specific roles and regulators. This plan was adequate as long as each firm was content with its assigned niche. Aggressive entrepreneurs sometimes attempted to break out of this rigid structure, but the regulators kept pace.

When the economy and interest rates began their wild gyrations in the 1970s, however, many firms found that new strategies and tactics of competition had become crucial for their survival. Innovation was also spurred by technological advances, such as improvements in computers and communications; by regulation-induced distortions in the market; and by new legislation. As this wave of change swept through the financial services industry, large cracks appeared in the federal regulatory structure—and calls for reform became widespread.

President Reagan endeavored to assert control over the reform process by convening a study commission. The Task Group on Regulation of Financial Services, chaired by Vice President Bush, began work in late 1982 and issued its recommendations earlier this year. As we shall see, those recommendations do not go far enough in the direction of simplification and consolidation; first, however, we shall examine in some detail the considerations that argue for and against revamping the current distribution of regulatory functions.

Andrew S. Carron is vice president-mortgage market research of Lehman Brothers Kuhn Loeb Inc. in New York City. Until recently, he was a senior fellow in the Economic Studies program at Brookings. His publications include Rescue of the Thrift Industry and The Plight of the Thrift Institutions.

The Case for Reforming a Disorderly Regulatory Structure

Figure 1—adapted from a chart prepared by the Task Group—portrays the seemingly arbitrary assignment of responsibilities in the current federal regulatory scheme. One institution may be subject to as many as five regulators, and one regulator may oversee nearly as many different types of institutions. (Even this diagram understates the degree of confusion; it omits credit unions, securities and commodities dealers, consumer protection controls administered by the Federal Reserve and the Department of Housing and Urban Development, and the subsidiary responsibilities of the Federal Reserve for national banks and of the Federal Deposit Insurance Corporation for national and state member banks.) But the case for change in the financial regulatory structure must rest on something more substantial than a desire for a tidy organization chart.

Inter-industry Competition

The increasing competition among formerly distinct industries requires a greater consistency in regulation as well as broader coverage. Thrifts and banks are now much more alike, because each of these groupings has been granted authorities formerly the exclusive preserve of the other. Depository institutions have set up affiliates to sell securities as broker-dealers offer new accounts and services to compete with banks and thrifts. And all institutions, whatever their past successes, must meet the challenges presented by unregulated firms, innovation, and economic and demographic shifts.

Consider, as an illustration of the current disparities in regulatory policy, the rules governing the emerging competition between banks and thrifts. Banks have a generally broader range of investment alternatives than thrift institutions. But with regard to nonbank activities—those lines of business that must be carried out through a holding company affiliate or a service corporation—the rules for thrift institutions are more permissive. A unitary savings and loan holding company (i.e., one with only a single S&L subsidiary) may engage in any activity; multiple S&L holding companies are restricted to services determined by the Bank Board to be incidental to the main thrift activities.

In contrast, bank holding companies, be they unitary or multiple, are confined to a relatively narrow range of nonbank functions. Similarly, a thrift service corporation may engage in a wide variety of activities reasonably related to the operation of the thrift, whereas bank service corporations have only limited powers. These differences arise in part from legislation, but they principally reflect asymmetrical interpretations of appropriate activities by the two regulatory agencies involved.

As the competition between banks and thrifts intensifies, there will inevitably be justifiable claims of unfair advantage. Even today, there is direct competition between banks and thrifts for most kinds of deposits, many types of loans (e.g., mortgage, consumer, and student), and the full range of bank holding company

and service corporation activities. Congress may address some of the regulatory inconsistencies through new legislation specifying more precisely the powers of depository institution holding companies and service corporations. However, the technical knowledge and level of detail required to resolve these issues suggest that they would best be left to the regulatory process. Consolidation of regulatory authority therefore seems appropriate as a means of promulgating consistent rules.

Gaps, Overlaps, and Conflicts

When two or more agencies share responsibility for the safety and soundness of a depository institution, the division of duties can lead to problems because no single agency is ultimately in charge. Consider the case of bank holding companies. They are regulated, examined, and supervised by the Federal Reserve. The bank subsidiaries may also be under the jurisdiction of the Fed (if they are state-chartered banks and members of the Federal Reserve System), but they are more likely to be national banks regulated by the Comptroller of the Currency or state banks subject to the controls of state banking agencies and the Federal Deposit Insurance Corporation. Nonbank subsidiaries of the holding companies are generally unregulated.

The failures of three bank holding companies in the 1970s illustrated the consequences of divided regulation. Each of the companies had a national bank as its major subsidiary, which meant that regulatory coverage was divided between the Federal Reserve and the Comptroller of the Currency. Nonbank subsidiaries of the three holding companies then became involved (legally) in real estate, selling many of the loans to their bank affiliates. The fact that these transactions took place between affiliates, rather than at arm's length, was not detected due to the regulatory arrangement. Although each subsidiary was supervised, transactions among them were not. When the real estate market slumped in the mid-1970s, many of these loans defaulted, causing the banks to fail. The Federal Reserve has since attempted to extend its authority through the holding companies to reach the subsidiary institutions. This effort to close the gaps in regulation has led to conflicts between the Fed and the other bank regulatory agencies. And the system is still insufficient: The impending failure of a Tennessee bank holding company last year was not detected because its various subsidiary banks and thrifts were separately regulated.

The setting of margin requirements for securities transactions also involves the possibility of interagency conflict. These requirements—which mandate partial cash backing for purchases of stocks and bonds—serve two purposes that are properly the concerns of the SEC: They help to curb speculation, and they promote confidence in the markets. But margin-setting is lodged with the Federal Reserve Board, which sees it as a tool of stabilization policy akin to deposit reserve requirements. Although the SEC does not openly challenge the Board's policy, broker-dealers have long urged the Board to relax margin restrictions on certain new financial instruments (such as conventional mortgage-

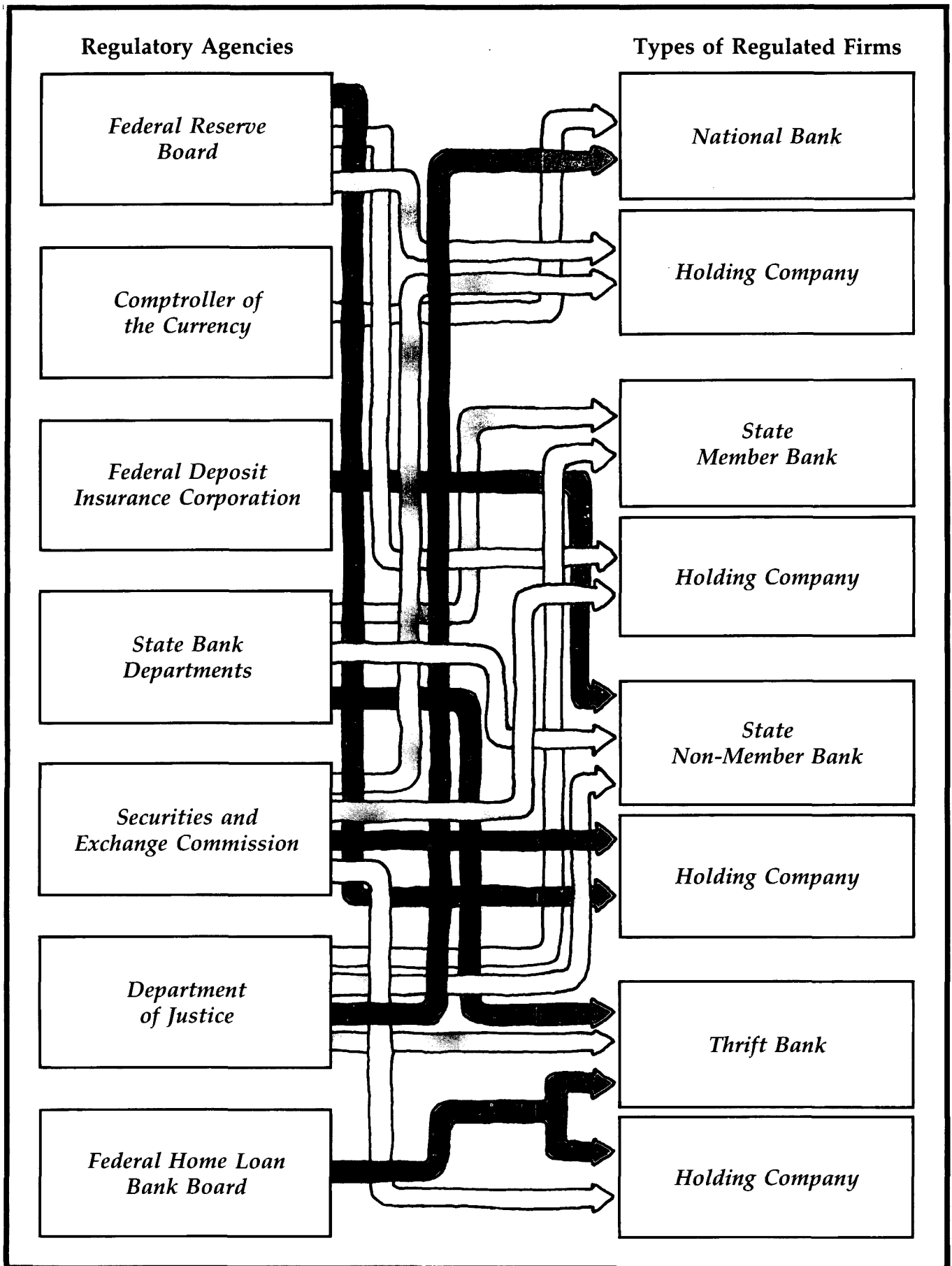


Figure 1

The Current Regulatory Structure

Federal Reserve. Established in 1913 to provide nationwide check-clearing, consolidate required reserves in the central bank, and set up a mechanism for lending to banks. Controlled by a seven-member Board of Governors. Operates through twelve regional banks with twenty-five branches. Supervises and examines state-chartered banks that are members of the Federal Reserve System. Supervises and examines all bank holding companies (the predominant form of bank ownership), regardless of charter. Administers certain consumer protection laws for all depository institutions.

Comptroller of the Currency. Established in 1863 as an office of the Treasury Department to charter national banks (only state charters until that time). Also examines and supervises national banks.

Federal Deposit Insurance Corporation. Established in 1933 to protect depositors in closed banks and, more generally, to promote a sound and viable banking system. Insures deposits at virtually all commercial banks and most mutual savings banks. Examines and supervises state-chartered banks that are not members of the Federal Reserve System.

State bank departments. Charter, regulate, supervise, and examine banks and thrift institutions where state chartering provided for under state laws. Have limited powers with respect to national banks and federal savings institutions. In practice, share authority over state-chartered institutions with federal deposit insurer.

Securities and Exchange Commission. Established, under 1933 and 1934 legislation, to restore confidence in capital markets by regulating broker-dealers and the exchanges on which stocks, bonds, and other financial instruments are traded. Authority extended to mutual funds in 1940. Specifies and enforces public disclosure requirements, sets rules of conduct for broker-dealers and exchanges, and assures that corporation rules permit adequate shareholder participation.

Department of Justice. With respect to financial institutions, may review proposed changes in industry structure and may sue to block them.

Federal Home Loan Bank Board. Created in 1932 to provide a credit reserve for savings institutions. Responsible for chartering, regulating, examining, and supervising federally chartered savings and loan associations. Federal Savings and Loan Insurance Corporation established in 1934 under control and management of Bank Board to insure accounts at member institutions, including state-chartered associations.

National Credit Union Administration (not shown). Established in 1970 to charter and supervise federal credit unions and to regulate, examine, and insure federal credit unions and insured state-chartered credit unions.

backed securities) for which the rules are excessively stringent relative to those for comparable, but more familiar, securities.

When federal agencies are called upon to assist a failing institution, the most efficient approach may involve the simultaneous application of measures under the control of different regulators. The need for coordination can impede the resolution of bank problems. For example, in the case of national banks, the Comptroller can arrange mergers, the Federal Reserve provides a liquidity facility (the discount window), and the FDIC has certain assistance powers. But all of the agencies involved must agree on the need for and the proper course of assistance. Remedial action may be delayed because of divergent views among the agencies. A regulator may be reluctant to act unilaterally because that could induce banks to change their charters in search of a less stringent agency. Even if prompt steps are taken, coordination among agencies requires time and effort, which are costly. A major difficulty is that the three principal federal bank regulators have different primary goals: The Comptroller's major interest is maintenance of a sound banking system; the Federal Reserve is chiefly concerned with the soundness of the economy and the stability of the money supply; and the FDIC has preservation of the insurance fund as its objective. These goals are not necessarily consistent.

Two examples illustrate the potential for problems. The first concerns the San Francisco National Bank, which encountered severe financial difficulties in 1964. The Comptroller was aware of the bank's condition and took steps to remedy the problems, but did not inform the Federal Reserve or the FDIC of what it had found. The bank was placed in receivership the next year, but that step came only after substantial and perhaps costly delay.

Second, in 1974 Franklin National Bank suffered investment losses that threatened its continued existence. The Comptroller had the authority to close the bank, but sought a merger partner instead. While this search took place, uninsured depositors withdrew funds from the bank, necessitating substantial advances from the Federal Reserve System. But there was insufficient collateral for these advances, so the FDIC was asked to guarantee them. This the agency was reluctant to do without assurances from the Comptroller that the problem would be resolved quickly. Coordination was eventually achieved, but, again, only after considerable delay. Indeed, it was not until late 1983 that the Comptroller of the Currency agreed to "invite" the FDIC to examine problem national banks, never acknowledging the right of the FDIC to do so on its own authority. When necessary measures are postponed, problems become difficult—and perhaps more expensive—to correct.

Differing Goals

Competing regulatory objectives create difficulties even when the issue is not a failing bank. Regulators want to promote safety and soundness, but they are also charged with maintaining competition, fostering innovation, and meeting the needs of the community.

The latter set of goals necessarily entails a tolerance for risk-taking and the possibility of failure.

In the case of bank regulation, the FDIC exerts a conservative influence while the chartering authority (Comptroller or state) encourages development and growth. There is no uncertainty on the part of the agencies as to their respective roles, but there is a continuing tension as they pursue different ends. Because bank chartering authority is independent of the FDIC, the insurance agency's concerns about risky behavior on the part of banks is not always taken into account. Similarly, the chartering authority is powerless if the FDIC uses its insurance regulations to restrict bank activity unduly. There is no reason to expect that the policy balance achieved in this manner is the correct one.

One of the most serious conflicts occurred during the mid-1960s between the Office of the Comptroller of the Currency and the other federal regulators. The Comptroller had ruled that national banks could enter a number of new lines of business under that part of the Banking Act providing for "incidental powers." Among the new authorities were corporate savings deposits, purchase of corporate stock, and underwriting of municipal revenue bonds. The Comptroller also permitted banks to use accounting definitions that effectively relaxed certain loan and capital restrictions. The Federal Reserve, which also has authority over national banks, objected, and there followed a series of legal battles. In the course of the dispute, the Comptroller withheld examination reports from the FDIC, which may have impaired the insurance agency's ability to address in a timely fashion the problems of the San Francisco National Bank. This disagreement persisted for several years.

Other issues have been resolved more quickly, but often by virtue of the size and prestige of the larger agency involved and not for substantive reasons. There has been much uncertainty among national banks as to what activities were legal, and state-chartered banks have felt that they were being unfairly treated. Obviously, these complications would not have occurred had there been but one agency in charge.

Most of the examples of disarray that have been cited have dealt with banks. That is because there is only one federal agency involved in the regulation of a given thrift institution, credit union, securities dealer, or

commodity broker. (There have been conflicts between the Securities and Exchange Commission and the Commodity Futures Trading Commission over such instruments as futures and options on financial instruments, but in general the divisions of responsibility between these agencies are clear.) For the Federal Home Loan Bank Board, the National Credit Union Administration, the SEC, and the CFTC, policy debates are internal. A decision is made on the desired tradeoff between safety and competition, and policies are set to attain that balance. Any errors or deviations can be quickly detected and regulation adjusted accordingly. If the decisions of a single agency are incompatible with overall government policy, they can be corrected. It is more difficult to develop and implement a consistent policy when instructions must be given separately to two or more agencies, each of which will react to the others' shifts in rules and procedures.

State-federal Conflicts

Our focus on confusion and inconsistency at the federal level should not obscure the fact that conflicts between state and federal bank regulators are also not uncommon. These usually involve banks or thrift institutions that are state-chartered and federally insured. State regulators may be less restrictive, because the consequences of error (i.e., bank failures) are largely transferred to the federal deposit insurance agency. The FDIC and Federal Savings and Loan Insurance Corporation therefore attempt to use insurance regulations to control more broadly the activities of state-chartered institutions.

This pattern of intergovernmental friction is evident in the federal reaction to a recent expansion of the investment authority granted to state-chartered savings and loan associations in California. The FSLIC proposed a rule to deny deposit insurance to institutions that engaged in certain of the newly sanctioned activities. Unless it can be shown that implementation of this rule would exceed the Board's statutory authority, state institutions will be compelled to accede. Federal deposit insurance is a virtual necessity, giving the deposit insurance agencies great leverage over state regulators. The principle of dual banking can survive only to the extent that the states adhere to the general guidelines set down by the federal agencies.

Opposing Views

There are four main arguments against consolidation of the bank regulatory agencies. Chief among these is the proposition that the existing system has worked reasonably well. The current arrangement is also seen to have certain virtues of diversity and decentralization: It is suggested that giving firms a choice of regulators encourages the agencies to be responsive to their needs (point two) and that having several regulators share authority over particular types of firms keeps the agencies from getting too close to the industry (point three). Finally, some claim that the differences between and among banks and thrifts continue to outweigh the simi-

*"There is no reason to expect
that the policy balance
achieved in this manner
is the correct one."*

larities, so that specialized regulation is still appropriate. These arguments have been made by different groups at different times, and they are not necessarily consistent with each other.

Performance of the Old System

It is difficult to make the case that the regulatory agency system in place for the last fifty years has seriously impeded the development of the financial services industry. In general, stability has been maintained; although bank failures have occurred, the causes have had little or nothing to do with the regulatory agencies. The issue, then, is whether the financial sector has changed so much that past experience is no longer an adequate guide to the future. Recent developments have certainly shaken some of the pillars of the existing regulatory framework—among them the separation of banking and commerce, restrictions on investments by banks and thrifts, and prohibitions on interstate branching.

Competition in Laxity

One of the advantages that the current system is said to confer is a check on the power of regulators. If one agency has more stringent, less innovative, or more cumbersome policies than the others, then—or so the argument goes—firms now under its jurisdiction will seek to escape by changing their charters, and new firms will organize themselves so as not to fall within that regulator's purview in the first place. Agencies are seen as competing with each other for jurisdiction over financial services firms by offering those firms attractive operating conditions.

This view of the regulatory process—as a competition in laxity—has generated a good deal of debate. There seem to be two major points of contention: first, whether agencies do in fact compete in the posited fashion; and, second, if they do, whether competition of this sort is desirable. The evidence is mixed on both issues.

As to the first, regulators sometimes disagree—for any number of reasons—in their conceptions of the most desirable market structure for financial institutions, and, accordingly, their decisions on proposed mergers, branches, or holding companies may differ. The recent acquisition of a state bank by a securities firm, on which the FDIC and Federal Reserve have sharply divergent views, is a case in point. It is not uncommon for institutions to attempt to structure transactions so that they come under the jurisdiction of the regulators most likely to approve of them.

It is in the granting of asset, liability, and service powers that regulatory practices have been most diverse. Thus, in the 1960s the Office of the Comptroller took a more liberal view of banking law than other federal regulators: It excluded certain bank liabilities from classification as deposits, thereby reducing reserve requirements; it permitted banks to underwrite municipal revenue bonds; and it allowed them to establish less-regulated subsidiaries to offer bank-like functions. A number of banks, including the Chase

“... consumer demand eventually leads to regulatory acceptance of desirable innovations.”

Manhattan Bank, switched to national charters in order to secure the advantages that the Comptroller's interpretation would confer.

The numerous changes of charter that have been made may be evidence of a flight to leniency, but other explanations are also plausible. Many banks and thrifts have chosen federal charters even when state regulation would have afforded them more latitude, because they found it simpler to deal with a single regulator. In any case, the number of changes has been small relative to the size of the industry, and—despite the diversity in regulatory stringency and the relative ease of changing charters—there remain many institutions in each category.

A strong case can be made that the incentives for regulators to safeguard the public interest outweigh any inclination they may have toward laxity. Examination is the heart of the supervisory process and the mechanism through which the agencies most directly affect the operations of individual firms. No regulator is likely to condone—in order to accommodate regulated banks or thrifts—violations of law that it uncovers. If an agency were to overlook illegalities, the failures and lawsuits that inevitably would accrue would be attributed to supervisory incompetence. Indeed, regulators will always be judged by the success of their decisions and oversight—an important check on laxity.

It has been argued that regulatory forbearance is beneficial because it fosters innovation. This is a misconception, however; innovation is motivated by market forces, not laxity. Firms will continue to develop new products and services regardless of regulatory restrictions. The history of financial regulation has shown that consumer demand eventually leads to regulatory acceptance of desirable innovations.

Moreover, the new regulatory environment reduces the role that agencies can play in controlling the development of the industry. Statutory limitations on industry activity are now less stringent than they once were and, therefore, leave fewer decisions in the hands of regulators. Distinctions between the banking and thrift industries are less numerous, narrowing the potential differences in regulatory practice. Perhaps most important, a large unregulated financial sector now exists to provide a competitive check on excessive regulatory stringency.

The Long History of Reform Proposals

The Vice President's Task Group is only the latest in a long series of reorganization efforts. Between 1919 and 1921, four separate bills were introduced in Congress to consolidate the functions of the Federal Reserve and the Office of the Comptroller of the Currency. With the proliferation of regulatory agencies in the early 1930s, the reform proposals began in earnest.

Brookings Study.

As part of a comprehensive analysis of the federal bureaucracy that it conducted for a Senate committee, the Brookings Institution proposed a plan for financial reorganization. The Office of the Comptroller was to be abolished and authority over national banks transferred to the FDIC. Examination and supervision of state banks would have been moved from the Federal Reserve to the FDIC, making the insurance agency the principal bank regulator at the federal level. This strengthening of the FDIC was intended to give it powers commensurate with its responsibility to protect deposits. Legislation to accomplish this reorganization was introduced but not enacted. During 1938 and 1939, other bills were proposed that would have transferred the FDIC and the supervisory functions of the Federal Reserve to the Treasury Department, where the Comptroller of the Currency resides.

Hoover Commission.

Three separate task forces set up under the Hoover Commission called for centralization of federal bank regulatory authority. One recommended transferring the FDIC to the Federal Reserve Board, the second suggested moving the Comptroller to the Board, and the third proposed that all federal banking agencies be consolidated into the Board. The Commission itself rejected all of these options in favor of a fourth, that of transferring the FDIC to the Treasury Department.

Reorganization Plan No. 2.

Federal regulation of savings and loan associations came under review in response to the Reorganization Act of 1956. Whereas proposals for reform of bank regulation had emphasized consolidation, the plan sent to Congress by President Eisenhower called for separating the FSLIC from its operating head, the Federal Home Loan Bank Board. Reports by the General Accounting Office and the Second Commission on Organization of the Executive Branch of the Government had asserted the existence of a conflict between the provision of deposit insurance and other regulatory functions. Their concern was that the Bank Board might grant charters to unsound institutions, increasing the risk exposure of the FSLIC. In Senate hearings on the proposal, however, it became apparent that separating the chartering and insurance decisions (the bank regulation model) would heighten the potential for conflict

and remove the prudential incentives that existed under unified authority.

Commission on Money and Credit.

In 1961, the Commission on Money and Credit proposed a sweeping consolidation of federal bank regulation. Bank examination and supervision functions of the FDIC and the Comptroller were to be transferred to the Federal Reserve System. Deposits in mutual savings banks, then as now insured by the FDIC, would be brought under the authority of the FSLIC, concentrating regulation of thrift institutions under the Federal Home Loan Bank Board. Subsequent legislative proposals would have gone even further, by merging the Comptroller, Federal Reserve, and FDIC into a single new agency. Another bill would have consolidated the two federal deposit insurance agencies, without affecting the other regulatory powers of the Federal Home Loan Bank Board.

Senate Investigation into Federally Insured Banks.

Disputes between state and federal regulators, and among the federal agencies, came into the open during a series of hearings in 1965. The Bank Board complained about state authorities that had failed to discipline state-chartered savings and loan associations engaged in illegal or improper activities. The FDIC noted that lack of cooperation on the part of the Comptroller and the Federal Reserve had impaired the bank examination process.

Hunt Commission.

In 1971, the President's Commission on Financial Structure and Regulation, more commonly known as the Hunt Commission, recommended the establishment of a Federal Deposit Guarantee Administration, incorporating the FDIC, the FSLIC, and the credit union insurance agency. The Administrator of National Banks, a new organization separate from the Treasury, would have replaced the Office of the Comptroller of the Currency and would have taken on the chartering, examination, and supervision of federally chartered mutual savings banks. The Administrator of State Banks, another new agency, would have assumed the Federal Reserve's regulatory, examining, and supervisory responsibilities towards state-chartered, federally insured commercial and mutual savings banks. The regulatory and supervisory functions of the FDIC, except those relating to the determination and collection of insurance premiums, would have been transferred to the Administrator of State Banks.

Compendium of Major Issues in Bank Regulation.

In 1975, the Senate Banking Committee commissioned a series of papers from non-governmental experts on structural reform issues. Several papers recommended shifting regulatory and examination powers to the

FDIC, largely because of that agency's ultimate responsibility for all insured banks. Also proposed was creation of a Federal Banking Commission to be placed in charge of all regulatory and supervisory activities and to have a separate division to carry out insurance procedures. This proposal reflected not only the usual arguments regarding efficiency and consistency, but also a strong concern about lax supervision under the existing arrangement. During the preceding year, two of the largest banks in the U.S.—Franklin National Bank and U.S. National Bank of San Diego—had failed.

FINE Study.

The next major set of hearings on reform of the regulatory apparatus were held in 1975 by the House Committee on Banking, Currency and Housing. The hearings resulted in four volumes of reports and testimony entitled *Financial Institutions and the Nation's Economy (FINE) "Discussion Principles."* The FINE study was actually the first to recommend that all of the federal banking and thrift industry regulatory bodies be consolidated into a single new agency. One witness proposed a period of transition, with that consolidation being made to depend on the extent to which banking and thrift institutions became homogeneous in function. Also advanced was an alternative to the FINE consolidation plan—functional realignment of the existing agencies—under which the Comptroller would be responsible for optimizing individual bank performance and defining permissible activities for banks; the FDIC would be in charge of the safety and soundness of banks and would have sole authority to conduct bank examinations and to declare banks insolvent; and the Federal Reserve System would be responsible for maintaining the competitive structure of the banking sector and would be accorded jurisdiction over mergers. This structure differed from the FINE proposal in that the various functions would remain under separate organizations rather than within administrative units of a single agency. This alternative was intended to avoid concentration of power and to assure that conflicts among the goals inhering in the different functions would be debated openly, with Congress as the final arbiter. (These themes are echoed in the recommendations of the Vice President's Task Group.)

Study on Government Regulation.

In a 1977 analysis, the Senate Governmental Affairs Committee proposed the consolidation of commercial bank regulatory activities into a single federal bank agency. The recommendation was motivated by a desire to eliminate the inconsistencies among the Comptroller of the Currency, the Federal Reserve, and the FDIC concerning bank merger and holding company regulation. The Consolidated Banking Regulation Act of 1979 would have merged the administration of banking examination, supervision, and regulation into a five-member Federal Bank Commission.

Regulatory Capture

One common criticism of regulatory agencies is that they eventually come to serve the interests of the industries that they regulate rather than the public interest. That is because agency officials have daily contact with firms in those industries and measure their own success in terms of the health of the regulated. Unfortunately, that health can be the result of regulated prices being set too high or of competitive firms being excluded from the market. This identification of the regulators with the regulated is termed "regulatory capture."

The current dispersion of authority is seen as inhibiting regulatory capture. On the one hand, when a category of financial institutions is regulated by multiple agencies, the differences in agency objectives and procedures will make it more difficult for that category to secure a consistent set of policies working to its advantage. On the other hand, when an agency regulates more than one category of firms, it is less likely to adopt the perspective of any particular one of them.

Capture can take place, however, only when a regulatory agency is able to provide advantages to the firms under its aegis. Competition from unregulated firms can reduce or eliminate these advantages. For example, the Federal Home Loan Bank Board may have taken actions in the past to shield savings and loan associations from market forces. But today, even though the Bank Board is the sole regulator of federal savings associations, challenges from outside the industry would prevent it from raising the profitability of the associations or restricting the competition that they face. Even if banks were brought under common regulatory control, there would still be myriad securities brokers, mutual funds, and others able to compete unfettered.

Specialized Institutions

The banking, thrift, credit union, and securities sectors developed separately, with specialized regulators. Despite the innovations of recent years, firms and agencies still differ substantially from sector to sector. Although these variations may fade with time as firms exercise their increased flexibility, some feel that the blurring of distinctions among sectors—and of regulatory boundaries—is neither inevitable nor desirable. Thus, banks doing securities business seek to minimize SEC intervention in their activities; state-chartered institutions resent the intrusions of federal agencies; and national banks prefer to have the Comptroller alone—and not the Federal Reserve or FDIC—monitor their operations. Other observers argue in favor of "functional regulation"—the notion that firms engaged in similar activities should be regulated, insofar as those activities are concerned, by the same agency.

The savings and loan industry opposes the merger of the Federal Home Loan Bank Board or FSLIC with any of the federal agencies that regulate banks. Its position is based in part on the differences—in structure and condition—of banks and thrifts today. But both the thrift industry and the Bank Board also assert that specialized regulation is necessary to support the social

"The Task Group's difficulties in reaching a consensus are reflected in the apparent inconsistency between the regulatory structure proposed for thrifts and the one recommended for banks."

mission that thrifts perform of providing housing finance—and that this function of thrifts should continue. This much broader issue is beyond the scope of the present article, but two points can be noted briefly. First, Congress enacted legislation in 1980 and 1982 that permitted thrift institutions to invest in assets and accept liabilities previously restricted to commercial banks. It clearly intended for thrifts to reduce their reliance on mortgage investment (although industry growth was expected to permit absolute increases in housing loans) and to compete with commercial banks. Second, it is not axiomatic that a consolidated regulator of banks and thrifts would be incapable of carrying out the government's housing finance policy.

Those who favor fragmented regulation also express concern that if one agency is folded into another, the regulatory balance may tilt toward the categories of firms traditionally within the ambit of the surviving agency. Decisions of the consolidated agency might systematically favor national banks over state banks, banks over thrifts, stock institutions over mutual firms, or large entities over small ones. That potential exists even today. The deposit insurance agencies have long had a diverse membership. Both the FDIC and FSLIC insure many sorts of institutions: federal and state, stock and mutual, large and small. And the FDIC has some supervisory powers over both commercial banks and thrift institutions. Claims of favoritism are hard to evaluate, however, because institutions still differ enough to warrant dissimilar treatment.

The Bush Report

The mission of the Vice President's Task Group was to develop a plan to rationalize the structure of financial regulation. In pursuit of that mission, it traversed much of the same territory that had been covered in earlier efforts dating back seventy years. Since 1913, when the Federal Reserve System became the second federal bank regulatory agency—joining the Comptroller of the Currency, established in 1863—there have been nu-

merous attempts to consolidate or otherwise reform the agency configuration (see box). This most recent study group, however, was notable for the high government positions held by its members—the heads of the various financial regulatory agencies—and for the broad agreement within the group on its ultimate recommendations. Perhaps as a consequence of these characteristics, though, the proposals that emerged are quite modest in comparison with those of earlier commissions.

The Task Group recommended that much of the existing regulatory structure be preserved. Under its plan, the regulation of savings institutions would remain largely unchanged, with the Federal Home Loan Bank Board retaining its current role. The composition of an institution's asset portfolio would determine whether it would be treated for regulatory purposes as a bank or as a thrift; if the portfolio contained less than a stated proportion of mortgage loans, the institution would be defined and regulated as a bank regardless of its charter.

More substantial changes were proposed for bank regulation. The Office of the Comptroller of the Currency would be renamed the Federal Banking Agency and would have authority over most bank holding companies in addition to its current functions vis-a-vis national banks. The Federal Reserve would give up its regulation of bank holding companies—except for fifty or so "international class" holding companies, which are the largest financial institutions in the country. (Although the U.S. has over 14,000 banks, these fifty largest account for one-third of industry assets.) At the same time, the Fed would inherit the FDIC's supervisory and examination powers over state-chartered banks. Enforcement of antitrust, securities, and consumer protection laws as they apply to the financial services industry—responsibilities that now rest with the several bank and thrift regulatory agencies—would be transferred to the Department of Justice, the Securities and Exchange Commission, and the Federal Trade Commission respectively.

The Task Group's difficulties in reaching a consensus are reflected in the apparent inconsistency between the regulatory structure proposed for thrifts and the one recommended for banks. The group believed that a unified regulatory structure would be appropriate for the thrift industry, yet decided that a multiple-agency configuration would be correct for banks. Thus, the potential for regulatory conflicts would be reduced, but not eliminated. The Federal Reserve, the new Federal Banking Agency, and state banking agencies would all have some authority over bank holding companies, necessitating coordination that is not required under the current system in which the Federal Reserve has exclusive jurisdiction. Even the Federal Banking Agency's authority to define permissible activities for holding companies would be constrained by the possibility of a Federal Reserve veto. Moreover, despite the withdrawal of routine regulatory powers from the FDIC, that agency would still be able to use insurance regulations to influence the activities of insured banks. The possibility for disagreements between the FDIC and state regulators would remain.

A simpler plan would have resulted had the group proposed transferring all of the Fed's regulatory powers to the new Federal Banking Agency. But the Federal Reserve argued strongly for retaining some jurisdiction. The Fed has long maintained that the regulation of depository institutions (primarily banks) affects monetary policy and, therefore, that the central bank should have regulatory authority over banks and thrifts.

The Federal Reserve's case for maintaining its regulatory jurisdiction over banks is based on three points: (1) Depository institutions offer transaction (checking) accounts, making them especially susceptible to deposit runs; (2) they provide liquidity to other institutions in times of financial stress; and (3) they play a unique role in the implementation of monetary policy through reserve requirements. These functions require a high degree of public confidence and justify the provision of deposit insurance and access to the lender of last resort. Each of the three assertions has been challenged: Third-party payment facilities are offered by nonbanks, there are many sources of liquidity other than depository institutions, and monetary policy is not solely dependent on bank regulation.

The more fundamental question is whether the Federal Reserve needs examination and regulatory powers in order to maintain confidence in the financial system or to spot unsound trends in their early stages. It is suggested that the manner in which financial crises are resolved and the dual role of bank capital requirements (protecting bank soundness and regulating credit expansion) demonstrate how intertwined monetary and regulatory policies are and must be. This is not an issue that can easily be dismissed; an incorrect conclusion could be calamitous. Therefore, it is both likely and appropriate that the Federal Reserve retain some role in the regulation of financial institutions. The Task Group's proposals in this area are inadequate, however. Although a regulatory role for the Fed would be preserved, several areas of overlapping authority would be created. If the Fed were given a clear but limited role in examining certain financial institutions and setting broad regulatory standards, day-to-day supervision could be left to the primary bank regulators.

The Path to Reform

The debates on reform of the financial regulatory structure have been striking in two respects. The first has been the sheer number of studies, panels, commissions, and recommendations that have been forthcoming in a nearly continuous flow since the early years of regulation in this century; this outpouring suggests that there has been widespread agreement on the need for reform. The second has been the repetitiveness of the arguments made throughout the years on all sides of the restructuring issue. One must conclude, therefore, that the time for study has passed. A decision on whether and how to reorganize the system can and must now be made on the basis of available information.

The current patchwork arrangement has been ade-

quate to the task of strictly delineating the powers and authorities of the various classes of institutions. While no one would design quite the same system if starting with a clean slate, its shortcomings have been offset by some modest advantages of diversity. A case for rationalization has always existed, but until recently it has not been compelling.

Now, however, the financial industry faces a future that will differ in essential ways from its past. Existing weaknesses in the current regulatory scheme, such as coordination problems in addressing inter-industry matters, will come under increasing pressure, while the system's greatest strength—its openness to diversity—will become less significant as the unregulated market becomes more important as both a source and a catalyst of innovation.

The emerging economic environment demands corresponding changes in the regulatory structure. There needs to be a single coherent policy toward financial institutions. It is inappropriate and inequitable to have agencies applying different criteria to otherwise similar firms. Federal regulation of depository institutions should be consolidated and centralized, and the more so the better.

The Task Group did not address the overarching issue of competition between traditional depository institutions that have long been subject to regulation and other firms that are not similarly controlled. Arguably, the panel's mandate did not extend to this topic, as the administration had already made clear its desire to broaden the areas of competition between the two groups and to apply common regulatory criteria to banks and nonbanks carrying out similar functions. That, however, is the crux of the matter. A redefinition of what constitutes "banking," and of what activities bank holding companies may safely conduct, is vitally needed. Such decisions on how the financial services industry—including what is now the less-regulated portion—should be organized must precede reorganization of the regulatory agencies. No regulatory system can hope to be successful without a clear statement of its objectives.

"The emerging economic environment demands corresponding changes in the regulatory structure. There needs to be a single coherent policy toward financial institutions."

Budget Deficits and Federal Reserve Policy

Robert Solomon

THIS ARTICLE EXAMINES the implications for monetary policy of the outlook for the federal budget. It is widely agreed that deficits in the range of \$180 to 200 billion, or possibly even higher, will persist for a number of years unless taxes are raised or federal expenditures are reduced. It remains to be seen whether and how much these prospective deficits will be pruned, but it is useful to explore how budget deficits of different magnitudes may affect monetary policy. This essay describes the processes by which monetary policy and the budget influence the economy, the ways in which monetary and budget policies interact, and some of the problems that may confront the Federal Reserve in 1984 and beyond.

The Impact of Monetary Policy

The Federal Reserve conducts monetary policy in an effort to promote a growing non-inflationary economy. It has three direct instruments with which to carry out its monetary-policy functions. The principal instrument, known as open-market operations, involves buying or selling securities (usually U.S. government securities) in the financial markets. In making its purchases, the Fed pays with checks or other claims on a Federal Reserve Bank. When these claims are deposited in the sellers' banks¹, those banks acquire additional deposits at the Fed. As a result, their reserves, and those of the entire banking system, increase. Thus, the Federal Reserve, by using open market operations, can affect with a fair degree of precision the amount of bank reserves or the interest rate (that is, the federal funds rate) at which banks borrow and lend with each other.

The second direct instrument in the hands of the Fed is its power to alter reserve requirements—that is, the proportion of deposits that banks are required to hold in the form of reserves. If the Fed reduces reserve requirements, banks can maintain a larger total of assets and liabilities with the same amount of reserves. This instrument is used only rarely.

The third instrument is the discount rate. This is the interest rate the Fed charges banks that borrow from the Federal Reserve Banks. A lower discount rate tends to encourage, and a higher rate to discourage, borrowing. Increases and decreases in borrowing from the Fed also affect total bank reserves.

When the Fed uses its policy instruments to increase reserves, banks are able to make additional loans or buy more securities. This shows up on the asset side of bank balance sheets as an enlargement of bank credit; on the liability side, it appears as growth of bank deposits. Bank deposits plus

Robert Solomon is a guest scholar at Brookings. He was formerly the chief international economist for the Federal Reserve Board. Among his publications are *The International Monetary System 1945–1981* and *The Interdependence of Nations: An Agenda for Research*.

assets and liabilities faster, interest rates tend to go down (assuming that the demand for money and credit is not rising even faster than the supply). The combination of lower interest rates and more readily available loans and investments at banks makes it possible for the public—individuals, home builders, corporations, foreign entities—to increase spending. Conversely, when the Fed reduces bank reserves, or their rate of increase, banks find it necessary to brake the volume of lending and acquisitions of securities. As a result, interest rates tend to rise and spending by the public slackens.

These variations in bank credit, which are mirrored by fluctuations in the money supply, affect interest rates and total spending (aggregate demand) in the economy. Thus, the Federal Reserve has an influence on the aggregate demand for goods and services. Some elements of demand are more responsive than others to changes in monetary policy. Residential housing, for example, is especially sensitive to interest rates. When mortgage rates go up, home buying is discouraged and housing starts tend to go down. When interest rates in general and mortgage rates in particular declined in the second half of 1982, residential construction increased strongly and helped to propel the economic recovery in 1983.

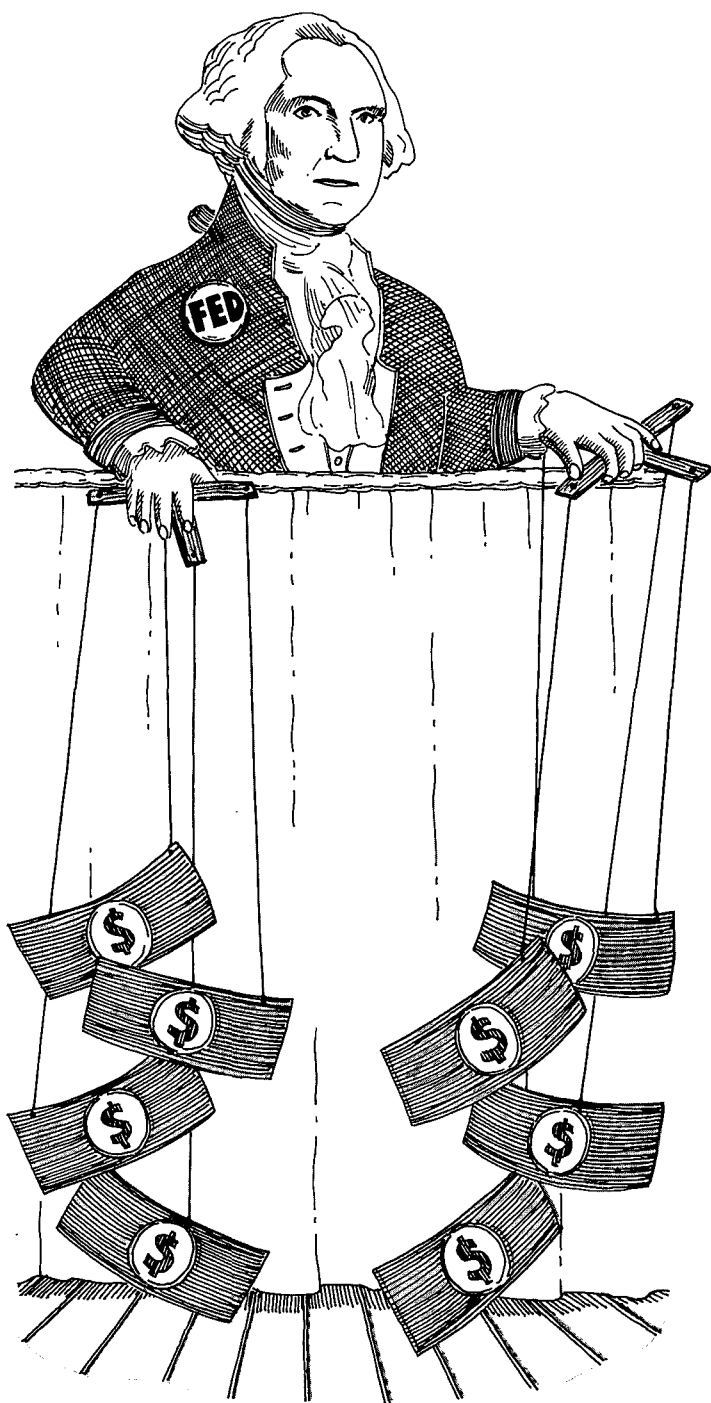
Other forms of spending are also affected by monetary policy. Consumer spending for automobiles and other durable goods may be influenced by changes in interest rates and in the availability of credit. Businesses are more cautious about adding to inventories and purchasing new equipment when they have to pay higher rates of interest on borrowed funds.

The channels through which monetary policy affects spending are not confined to bank lending. When banks are under reserve restraint, they purchase fewer, or sell more, securities. This has an impact on financial markets in general. The stock market tends to fall when interest rates rise, and businesses or others that might have financed investment spending by issuing new securities are discouraged from doing so. Moreover, rising or falling stock prices increase or decrease consumers' wealth, and these changes of fortune are reflected in their spending.

When Federal Reserve policy leads to higher or lower interest rates relative to interest rates abroad, exchange rates for the dollar tend to appreciate or depreciate accordingly. Of course, factors other than interest rates affect exchange rates—witness the depreciation of the dollar in early 1984. When exchange rates change, the result, after a lag, is a decrease or increase in the trade balance (which is also a component of aggregate demand).

In sum, the Federal Reserve influences, to varying degrees, all forms of private spending, and thus the market value of all goods and services produced (nominal GNP).

The Federal Reserve is often thought to have direct control over the rate of inflation. While changes in interest rates do affect price indexes, the major way in which monetary policy influences the price level is by affecting aggregate demand. When aggregate demand grows fast enough to narrow the gap between actual



Robert Wiser

currency in the hands of the public constitute the money supply,² of which there are several definitions, depending on which deposit liabilities of the banks are counted. These monetary aggregates, which are influenced but not precisely controlled by the Fed, are referred to as intermediate targets of monetary policy.

As a general rule, when the Fed supplies reserves more liberally and banks can therefore increase their

output and the capacity of the economy to produce goods and services, prices and wages tend to rise more quickly. When aggregate demand is depressed and there is much unemployment and idle capital, prices and wages rise less rapidly (as they did between 1981 and 1983) or even decline.

The Impact of Fiscal Policy

The federal government can affect aggregate demand through changes in the balance between its expenditures and its tax revenues (fiscal policy).

Federal spending, like private spending, exerts a demand for the potential output of the economy. The government employs part of the population. It purchases some of the output of the private economy. Through transfer payments—such as Social Security, Medicare, and unemployment compensation—it provides purchasing power to consumers, making it possible for them to spend for goods and services. Taxation, on the other hand, removes purchasing power from consumers and businesses, thereby leading to lower demand for goods and services.

When federal expenditures equal tax receipts—that is, when the budget is balanced—the government is commonly thought to have a neutral impact on aggregate demand. A deficit in the budget is thought to stimulate aggregate demand. A surplus is regarded as restrictive. In fact, each of these conceptions needs to be qualified.

Economists believe that a budget that is balanced at a higher level of expenditures and taxes is adding to demand more than a budget that is balanced at a lower level of spending and taxation. Furthermore, a deficit in the budget is not always stimulative. In a recession, tax revenues drop while unemployment compensation and welfare payments go up. Such shifts cushion the decline in incomes, but they do not stimulate the economy back toward high employment as would a legislated increase in spending or a cut in tax rates. These built-in stabilizers work in reverse during a period of excess demand and inflation, sometimes producing a desirable surplus in the budget.

It follows that to understand the impact of fiscal policy, one has to distinguish between, on the one hand, autonomous cyclical changes in the economy that affect the budget and, on the other hand, discretionary changes in the budget that affect the economy. To do this, economists calculate a cyclically-adjusted budget deficit or surplus—or, what comes to the same thing, they separate the overall deficit or surplus into its cyclical and structural components. In 1982 and 1983, for example, about half of the federal deficit was estimated to have been structural—that is, given existing tax and spending laws, this portion of the deficit would have existed even at high employment—and the other half cyclical.

In the absence of measures to raise tax rates or reduce outlays, the present structural deficit is expected to increase, largely as a consequence of rising defense spending and the tax reductions that have been legislated (including the indexing of tax brackets beginning in 1985). This projected increase in the structural deficit

will offset the reduction in the cyclical deficit that will accompany the expected growth in the economy.

The Treasury normally borrows to finance a deficit and repays debt out of a surplus. The effects on aggregate demand of such Treasury financing run in the opposite direction from the direct impacts of deficits and surpluses. When the Treasury issues securities to finance a deficit, it is competing with private borrowers in money and capital markets. The result is a tendency for interest rates to rise. How much they rise depends on the cyclical condition of the economy, the stance of monetary policy, and the supply of funds from abroad.

In a period of recession, private demands for funds are usually not strong, and monetary policy is typically easy. In those circumstances, the interest-rate effects of financing a budget deficit are relatively small. When the economy is expanding and is operating at a high level of output, private demands for funds are heavier, and monetary policy is more restrictive. In this case, the financing of a deficit results in a larger impact on interest rates and some “crowding out” of interest-sensitive private spending. This process may also be viewed in terms of the proportion of the economy’s saving that is absorbed by the government; in a period of prosperity, a budget deficit competes with private investment for the available saving.

Although the interest-rate movements associated with changes in Treasury borrowing tend to offset the effects of deficits and surpluses on aggregate demand, this offsetting is usually far from complete. Under most conditions, therefore, an enlarged structural deficit increases aggregate demand, and a shift toward structural surplus decreases aggregate demand.

Interactions of Monetary and Fiscal Policy

The Federal Reserve aims its policy instruments at certain ultimate targets: sustainable economic expansion and a minimum of inflation. But the Fed is able to influence only aggregate demand and therefore the dollar value of GNP. It cannot determine how an increase in nominal GNP is apportioned as between an expansion in real output and an advance in prices.

It should not matter to the Fed whether the GNP growth rate at which it is aiming includes more or less federal spending. What should matter is how fast *total* demand—public and private—will be expanding. The larger the structural budget deficit, the faster total demand is likely to be increasing. If the rate of growth of total demand threatened to generate inflationary pressures, the Federal Reserve could be expected to move toward a more restrictive policy designed to slow the rate of increase of nominal GNP.

What does this imply for monetary policy in the period ahead? It is generally expected that even if little or nothing is done to reduce the structural deficit this year, the economy will grow at a satisfactory rate in 1984. But given the present and prospective structural budget deficits, that growth will be achieved with less stimulus from monetary policy and more from fiscal policy. Even now, real interest rates are historically high. A more balanced mix of fiscal and monetary policies would keep interest rates lower, bringing a number

of benefits to the United States and the rest of the world.

Suppose, therefore, that measures were adopted in the next few months to reduce the deficit substantially. As these measures went into effect, the stimulus to aggregate demand from the budget would diminish. Some analysts argue that deficit reductions—by lowering the Treasury's demand for funds and the prospects for future inflation—would lead to a decrease in interest rates and an increase in private spending sufficient for adequate economic growth even in the absence of any explicit easing of monetary policy by the Fed. Others doubt that the decline in stimulus from the budget would be offset fully. If those doubts are well-founded, it would be appropriate for the Fed to raise its monetary targets when deficit-reducing measures are adopted.

A shift in the mix of fiscal and monetary policy need not have any effect on the rate of growth of nominal GNP in the short run—say, this year and next. But over a longer period, lower interest rates would probably induce more investment spending and hence more rapid growth in potential GNP.

Other effects of lower interest rates would be visible sooner. Developing countries with heavy debts would see their interest payments reduced. For each percentage point drop in short-term dollar rates, for example, Brazil and Mexico would each save more than \$500 million annually.

A decline in interest rates—and, perhaps more important, a weakening of the expectation that interest rates could rise sharply—would tend to accelerate the depreciation of the dollar in the foreign exchange markets. Developing countries would benefit, inasmuch as most of their debts are denominated in dollars although their exports are sold for a variety of currencies. Industrial countries could also gain, since they would be able to relax their own monetary policies—a step that would encourage more vigorous recoveries. Finally, if the depreciation of the dollar were to continue, it would eventually lead to a turnaround in the growing trade deficit of the United States. If the other elements of aggregate demand were strong when that reversal occurred, that would be good reason to make the combination of fiscal and monetary policies more restrictive.

The present posture of fiscal and monetary policies has been compared to having one foot on the accelerator and the other on the brake. Perhaps a more apt image is that of a long freight train being pulled by two engines, the first of which (representing fiscal policy) can have its pulling power altered only occasionally, while the second (monetary policy) has a throttle that can be moved at any time. When more power is applied to the fiscal engine, it is necessary to apply less to the second if the prevailing speed of the train is to be maintained. If the first engine's power is reduced, the throttle on the second will have to be opened wider. Furthermore, if the train should come to an upward or downward sloping grade (recession or excess demand), the monetary-policy engine would be the first one to have more power applied or its brakes used.

During the past three years, the throttle in the fiscal policy engine has been set to accelerate the train's speed. Those who worry do so because they fear that

even at such time as a normal cruising speed is attained, the fiscal-policy engine will continue to accelerate. This would require that the brakes be applied to the monetary-policy engine. While the train could conceivably continue to move along at the proper speed under those circumstances, the long-run effects are potentially damaging.

The Problems Facing the Federal Reserve in 1984

The Federal Reserve has projected that real GNP will grow at 4 to 4¾ percent in 1984; prices will rise 4½ to 5 percent; and, therefore, nominal GNP will increase 9 to 10 percent. Its announced monetary targets—growth of M1 by 4 to 8 percent and M2 and M3 by 6 to 9 percent—would probably be consistent with the realization of these projections at relatively stable interest rates under normal conditions.

However, there are reasons to think that conditions will not be normal. First, the growing GNP will very likely be accompanied by abnormally large demands for credit, with Treasury borrowing needs holding steady—instead of falling, as they usually do in a period of cyclical expansion—while private credit demands increase. The combination of Treasury and private credit demands is likely to put upward pressure on interest rates. Second, if expectations become widespread that the dollar will continue to depreciate, capital flows out of the United States would tend to raise interest rates here.

Furthermore, depreciation would lead to increases in the prices of imports and of American products that compete with them. Whether the resulting jump in the U.S. price level would prove to be an isolated event or the starting point for a sustained higher rate of inflation would depend largely on the response of wages to the price advance.

It has to be assumed that Federal Reserve policymakers are expecting the dollar to depreciate. But neither they nor anyone else would wish to see progress on the inflation front, achieved at high cost in terms of unemployment and lost output, dissipated in a renewed wage-price spiral. Thus, monetary policy would face a dilemma if the dollar were to fall sharply.

An irony in that situation is that the need to adjust the mix of fiscal and monetary policies would become somewhat less urgent. One of the arguments for lower interest rates, which would be possible if the budget deficit were smaller, is that they would help to bring down the exchange rates of the dollar. If the dollar is already falling on its own, that argument disappears.

But the numerous other reasons to cut the budget deficit and alter the policy mix remain valid.

-
1. Hereafter, the term "banks" will include all financial institutions that are subject to the Fed's reserve requirements.
 2. For a thorough examination of Federal Reserve instruments and their relationship to money supply, see Ralph C. Bryant, *Controlling Money* (The Brookings Institution, 1983).

William E. Brock on International Trade

William E. Brock has been the United States Trade Representative for the past three years. He is a former U.S. senator, member of the House of Representatives, and chairman of the Republican National Committee. In a conversation with Mark Goldberg of the Review, he discussed a wide range of topics, including the U.S. trade deficit, the international debt crisis, domestic content legislation, and the proposed Department of Trade and Industry.

Q The U.S. trade deficit jumped from \$42.7 billion in 1982 to \$69.4 billion in 1983, and administration economists are predicting that it could go as high as \$100 billion this year. What are the key factors driving the trade deficit up that rapidly?

The first factor was the U.S. recovery, which occurred ahead of any other country's and at a faster pace. That recovery, coupled with the really incredible deficits in this country, strengthened the U.S. dollar, which is now about 40 percent above where it was five or six years ago. As a result, we were placed at a remarkably difficult competitive disadvantage. Imports were relatively that much cheaper, and our exports were relatively that much more expensive. When you combine those shifts with the debt crisis and the global recession, you have all the ingredients of an extremely negative trade deficit. My only hope is that the projection of \$100 billion dollars is not excessively conservative, because the 1984 number could be higher than that. The difficulties we face this year and next year, unless something changes, are very, very real.

Q What is the prognosis now for the exchange rate of the dollar? Do you expect it to ease off a bit in the next year or two?

Well, I don't know. Last year at about this time most people were suggesting that the dollar could not continue for very long to be as strong as it was, and they expected a reduction in value in 1983. I personally felt that the dollar was going to continue to go up and said so. Unfortunately, I was lucky enough to be right about that.

The underlying strength of the dollar remains. Interest rates here are significantly higher than they are in other countries on a net-of-inflation basis—in part be-

cause we've done so well in bringing down the rate of inflation. But that still leaves *real* interest rates substantially higher than elsewhere. That difference will continue to draw money into this country and strengthen the dollar.

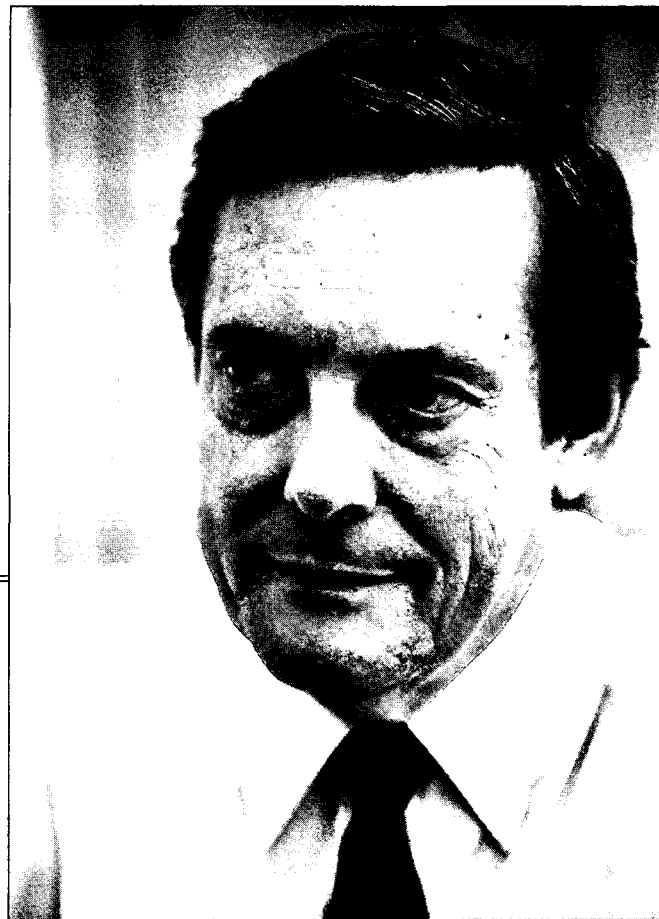
The dollar is still the reserve currency and, beyond that, the crisis currency of the world. And if you assume, as you must, that the world is going to be beset by continuing difficulty, that assumption argues for a strong dollar. The United States is the safe haven for world investment. It is politically and economically the most stable environment in the world and the country with the greatest prospect of growth in the immediate near term. Thus, it is a logical place to want to put money.

So unless there is a crisis of confidence—unless there is a sense that we might begin to lose again the battle against inflation—the dollar has every prospect of remaining exceptionally strong through 1984, in my judgment. That doesn't mean it might not drop a bit, but I'd be surprised if the fall were as much as 10 percent. This portends further trade difficulties for us in 1985.

Q Is there anything that the government can and should do about the overvaluation of the dollar?

Yes, but it has nothing to do with intervening in the value of the dollar. It has to do with macroeconomic policy. It is imperative that we come to grips with this deficit problem. No one would rationally suggest that we can solve the problem in the next year or two or three, but I think all of us believe that a commitment has to be made *now* to begin that process so that, within the next four, five, or six years, we can see some end to this excessive drain of our national wealth.

Beyond that, it is in my judgment time to begin a fundamental discussion about the make-up of our national tax policy. Is it logical to get all of our government resources from taxes on earnings, savings, and investment, as we now do? Or should we consider an alternative method of revenue-raising? We also need to assess the adequacy of the tax system's incentives for savings and investment. It's one thing for the Japanese to run a deficit that's 8 percent of their GNP; they can afford to



do that, at least for a while, because their rate of savings is something more than double ours. But we can't afford it. So either we change the deficit or we change the rate of savings, or we do a bit of both. Frankly, I would like the latter course: both.

■ Isn't the high valuation of the dollar making it more difficult for Europe and the less developed countries to have their own recoveries?

Absolutely. The European community feels—and so do a lot of other countries—that current levels of real interest rates here are draining their productive resources into this country, thereby making it more difficult for them to recover. And, in fact, their recovery is much slower than ours. I think there are a lot of other reasons for that. There's been too much government intervention, too much subsidy, too much willingness to substitute political judgment for market decisions in Europe in the last twenty years. But the Europeans do have a legitimate case when they complain that U.S. fiscal and monetary policies have some negative effects on our partners.

However, there are positive effects for Europe, because a very strong dollar makes their exports much more competitive in our markets. I do believe that the president has shown a lot of courage in resisting the overwhelming pressure for protectionism here, and we have seen a surge of imports. With a \$70 billion dollar trade deficit in 1983 and then \$100 billion dollars in 1984, the United States is doing a lot to act as the engine of economic recovery for the rest of the world.

■ What is the outlook now for the less developed countries that are burdened with enormous debts and that in many cases have had to cut back substantially on their imports from this country?

My own judgment is that we've got another five or ten years of very difficult times ahead of us. In all honesty, I think we have done a remarkably good job of managing a terribly difficult crisis thus far. But the question now is, what next? What about the longer term?

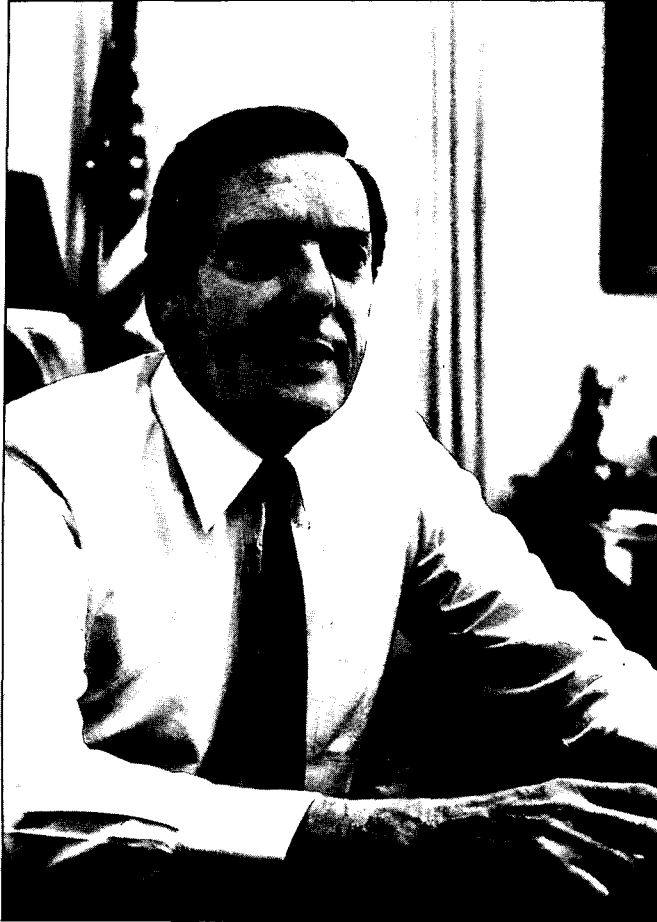
To take an example, Brazil has exports of \$21 billion a year and imports of \$15 billion, which seems to give

them a trade surplus of \$6 billion dollars. But their debt is pulling about \$12 billion dollars a year out of their economy, so there's actually a net disinvestment. If that continues for long, their ability to repay any debt will be diminished. It seems to me that we have to look at the adequacy, availability, and price of short-term commercial credit that will allow them to import. Increasing their imports would help the United States, because it would create jobs here. But in Brazil it's not just a matter of creating jobs; it's a matter of survival. They've got to import in order to restore their productive base so that they can export.

One of the things Don Regan and I have been trying to do for almost the last year now is to get trade and finance ministers into the same room just to talk about the interaction between trade and finance. This whole debt circumstance is the best illustration of the fact that these two issues are inseparable, and yet we seem to think we can pigeonhole each in its own little box and treat it as a separate entity. That's just not possible anymore.

■ Given the heavy indebtedness of some of the less developed countries, what's going to be required in order to make available expanded commercial credit?

First, and most importantly, it's going to take a bit more recovery, so we can get people thinking positively again. As long as people are trying to build up their reserves against a crisis, they will have a defensive, negative mentality that will create its own fruition. As the U.S. economy recovers—followed by the European



and Japanese economies—we will begin to buy more from the Third World, particularly from the debtor countries that have been so negatively impacted. The atmosphere will improve, I think, at that point.

We're going to have to look at the collective capital pool of the world financial system. We can't simply talk about U.S. deficits anymore, because we're dealing now with the availability of capital to countries that do not have the capacity to create their own. And that means we have to look primarily at capital formation in the industrial world.

Our deficits—and those of a lot of other countries—are absolutely insane. I don't know what word to use that is more horrible. Unless we raise the global rate of savings or reduce the drainage of governments, all we can expect to see is an increase in interest rates and a reduction in the availability of capital—and that foretells terribly difficult times ahead.

There is an alternative: If we can get our own economic houses in order—in Europe, in the United States, in Japan—if we can restore incentives for saving, then the opportunity for just an explosion of world trade is phenomenal. The pent-up demand is incredible out there. We're now down to a trillion, seven hundred million dollars worth of trade. There's no reason in the world why we couldn't be doing three or four trillion dollars worth of trade in the next ten years, if the capital is available—and that's the bottom-line question. Can we put our houses in order? Can we take into account the needs of our trading partners when we make ma-

croeconomic decisions in our own countries? We must.

15 Is it safe to infer from what you're saying that this is a particularly critical time to resist protectionist pressures—not only here, but also in the other industrialized countries?

Yes, but let's start with here, because we're the leader—and if we can't resist protectionism, nobody else is going to. The ultimate insanity is to think that we can ask others to pay their debts to us at the same time that we refuse to buy their products. That is just the essence of hypocrisy or myopia—take your pick. It just isn't possible. We have to keep our markets open, we have to tough out the current situation and make it work by getting this process back on the positive side. The U.S. economy is recovering, people are feeling better, there's a lot of hope out there now. Let's take that and use it to get positive again.

16 Are structural problems in American industry a major factor in our trade situation?

They certainly are a significant political factor. The pressures are very real. The adjustment is ongoing; it is painful, particularly in some of the heavier industries; and it is going to continue for some time to come.

One thing we have to be careful about is the constant inclination to blame our adversity on other countries, rather than looking to ourselves. I think Europe made that mistake back in the late '60s and early '70s. Because they believed in the trading system, they decided not to use barriers to protect themselves. Instead they used subsidies and government intervention—employment policies, laws requiring full employment, and the like. They ended up rigidifying their economic circumstances—they did not create any net jobs in the 1970s while we were creating 20 million—and now they have to pay a terrible price as they try to get back into the mainstream of competition.

If you look at this country, we are in what I believe is the fastest changing economy we have ever experienced. I think that the pace of change is going to escalate. And that's what's causing the political problem, because people can live with almost anything as long as it's regular and predictable and they understand it and

“ . . . if we can't resist protectionism, nobody else is going to. The ultimate insanity is to think that we can ask others to pay their debts to us at the same time that we refuse to buy their products.”

can plan for it. What's difficult is when the pace of change exceeds their experience. Then the pressures really rise — and that's where we are now.

But it isn't because of Japanese imports or Brazilian imports as much as because of innovation here. Let's take this incredible example: We're being asked to put a quota on imported steel of 15 percent of the U.S. market. The world has no free trade of steel that I can find. I haven't seen it for three years. It's a terrible zoo out there. Nobody plays by the rules — there are subsidies, barriers, tariffs, quotas, every other form of government intervention. It makes sense, at least on the surface, to say that we ought to be protected against such unfair trade. The problem is that we are protected against unfair practices already under U.S. law. Cases are being filed, and fair trade laws will be enforced. But we can't protect against fair competition, unless we want to die.

If you look at it, the fact is that steel imports have *declined* in the last two years. So has U.S. production. Why? Because there's been a shift from steel to other products, and that's going to continue. They're already experimenting with a ceramic automobile engine. You now see industrial plastic being used in place of steel. Cars are going to weigh less, because we want better mileage, and we'll use newer materials in making those automobiles. The fact that Ford automobiles weigh a thousand pounds less on the average than they did five years ago has had more to do with the difficulties of the U.S. steel industry than all those Japanese cars put together.

That's what we have to keep in mind as we decide what to do. The simple answer is to impose a trade barrier to protect ourselves and to freeze ourselves into a permanent noncompetitive circumstance. That won't work. Thus, if we're going to take an alternative course, we have to go back to what we were talking about earlier. How do we restore incentives for saving, for investment, for new R&D, new technology, new plant and equipment?

Then we have to look at the adequacy of our skill programs to see what we can do for the 45-year-old

steelworker who won't have a chance to go back to that steel job because it will never exist again. You've got to give that person an answer. You have no right to turn your back. So what is the answer? Is the Job Training Partnership Act enough? If not, what are the alternatives? Those are the questions we need to be asking and answering.

I do not think we can take the far more dangerous step that was taken by Europe 12 or 15 years ago of saying that if an industry or company is inefficient, we're going to subsidize it. That would ensure that all the areas currently competitive would be drained by higher taxes to subsidize the inefficient. The result would be that they too would become less competitive—and that's one road to national suicide.

⑥ Our trade deficit last year with Japan was \$21.7 billion. What does an imbalance of that size mean and is it something we should worry about?

No, it's something the Japanese should worry about, because that puts enormous pressure on us to restrain them and to kick their shins. It just isn't smart to have that circumstance maintained for very long.

For far too long, in fact, the Japanese simply protected their industries — new and old, large and small — and played by a different set of rules. In recent years they have begun to liberalize very consciously. The present prime minister has tried to do a good job in my opinion and has demonstrated a lot of integrity in trying to get Japan to reverse its course. They have a way to go, but in all honesty, if the Japanese were to remove all trade barriers today, in the next two years that step would do no more than cut our trade deficit with them in half.

The reason is that the other half of the equation is not in Japan — it's here. It is in the strength of the dollar, and it is in the fact that some of our industries got out of competitive whack. The automobile industry is a perfect example. I'm not casting blame or aspersion. I'm just simply stating a fact: that the Japanese today can produce a car for about \$2000 a unit less than we can. Under those circumstances, we've got to get ourselves together and get competitive — and until we do, we're

"...if the Japanese were to remove all trade barriers today, in the next two years that step would do no more than cut our trade deficit with them in half."

going to have a piece of that deficit. So part of the problem is in Japan — and we're working on that, we're making progress — but the other part of it is here, and we've got to be sure we're working on this aspect just as hard as we are on the first one.

15 Some members of Congress have expressed concern that the proposed Department of Trade and Industry might be more protectionist in international negotiations than your office has been over the years. And the response has been that a Department of Trade and Industry would only be as protectionist as the president it reported to. Assuming that that's correct, isn't it also true that this office — the office of the U.S. Trade Representative — has *institutionally* been committed to free trade?

You're right. Our softball team is called the Free Traders. Labels don't always mean what they say in Washington, but in this case that's accurate.

We do have a commitment to the world trading system, because we think that's where America's opportunity lies; we happen to believe—I happen to believe—that we're the most productive, competitive country in the world. We have temporary adversity with a strong dollar, but fundamentally we're the best — and that means that the opportunity is greater for us and we ought to be out there taking it. And that in turn means competing and opening up the trading system, liberalizing it.

Yes, we're free traders and that has been the predicate for twenty years of the U.S. Trade Representative. I hope that it would be the predicate of any department that has the primary responsibility for trade. But the comment is well-made, that a trade department — like the State Department — will reflect the policies and priorities of the president. And, frankly, that's as it should be. That's what people elect a president to do — to run the executive branch, to govern its policies — and I don't have any problem with that.

Whether this office is maintained or a new department is set up, I think the important thing is that the original design and reason for the existence of the USTR should be preserved. We were created because

there were so many turf battles between different agencies of government. Each department has its own cause in the area of trade, and what we need, if we're going to have a trading policy, is to have one department whose principal role is to coordinate, to pull together the various threads.

Those include the viewpoints not just of other government agencies, but also of the private sector. I have the most active private-sector advisory board room of any agency in government. I've got seven private-sector advisers for every employee in our entire agency. And I think that's great. I believe it gives us better answers per pound than anywhere else you can go in Washington.

16 The domestic content bill is something of a high-profile political issue these days. What are your views on the merits of that proposal and on the prospects for its passage?

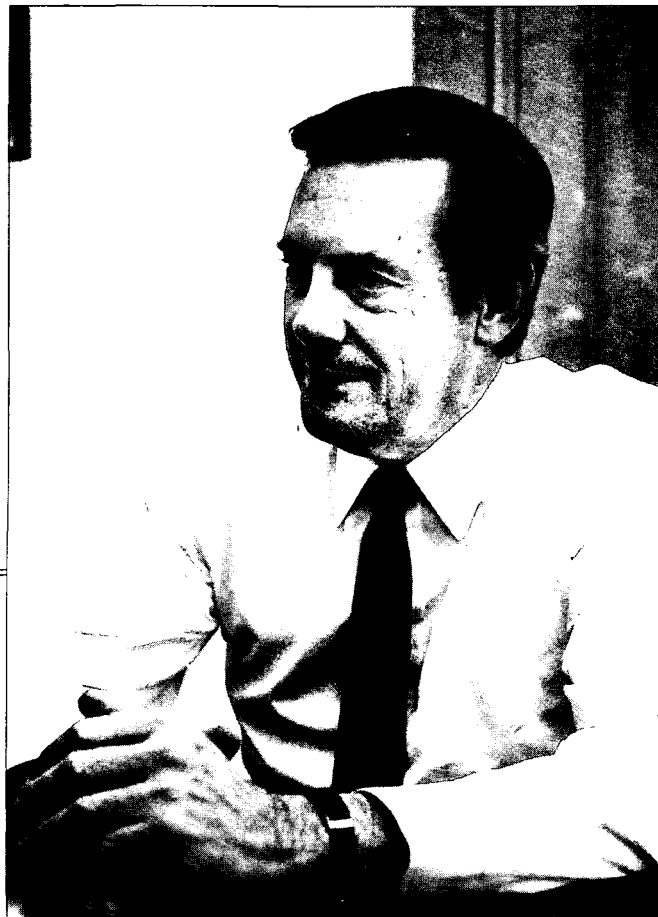
Well, I've said it was the worse piece of legislation since the Smoot-Hawley tariff brought on the Great Depression, but I was too kind. It's really just a terrible, self-defeating, shoot-yourself-in-the-foot bill that would do a great deal of damage to this country and its vital interests around the world. It would mean a loss of trading opportunities and a loss of jobs. It won't work, and the reason it won't work is that it's an effort to substitute the political judgment of government for the rather exquisite wisdom of the market place.

17 Do you think it's ever going to become law?

No, I don't think it's going to become law, no matter who the president is, because I don't believe that Congress will buy that kind of trash. I think that what they'll do is sign on it and try to get political credit with the advocates — and then they'll find some way to screw it up in the legislative process so it never becomes law. Nobody wants to make that kind of mistake, and most of the proponents know that it is not the best way to go.

18 What do you think the prospects are for a new round of GATT negotiations in the near term?

I hope that we don't try to go into GATT negotiations without a great deal of preparation. Certainly, 1984 is



premature for a final decision. Even so, a trading round could be a very important and useful exercise. I do believe in it. I've been talking about it for some time now, but to launch one requires very careful preparation. We don't yet have full acceptance of what we want to achieve, much less what our trading partners want to achieve.

So the first thing we need now is some quiet analysis in the United States as to what might be in our interest in such a round. Second, we need to have some very quiet conversations with our trading partners. And I do mean by that not just the industrial countries, but also countries in the developing world, because that's where the new markets are and they have a vital stake in a substantially free trading system. We have to take their interests into account not only because they're partners, but because they're important to us and their well-being is important to us.

It's a very complicated subject. My own hope is that we could have those quiet talks this year. Maybe by 1985 we could get into some public discussion of an agenda and not too long after that maybe actually begin the process.

Q Are there changes that you would like to see made in the way in which trade negotiations are conducted?

Oh, sure. I think the thing that troubles me most about the trading system as it has evolved is the fact that there is no institutional process available for some sort of ongoing, systemic purging of the old and development of new ideas. We have to talk about, as we just were, a trading round. It seems to me that if we ever really want the GATT to work, it has to become a continuing evolutionary process of negotiations, consultations, and dispute settlement. I think we have to give some thought to how that might be developed over a period of the next several years.

There is another complication in the GATT, and that is that it was developed primarily by countries that had market economies. The world has changed a great deal since those early, very nice days. There are very few market economies left in the world. Most are mixed, and a substantial number are non-market. The rules

really just don't take that into account, and it's very difficult to manage the system because of that.

The last concern that I have with the GATT is that it was designed originally, if you remember the old international trading organization that was first proposed, to look at all exchanges — goods and services, investments. The United States probably felt that was a little bit too ambitious, so we decided to limit ourselves to those things tangible — things that you could see, touch, taste, feel, or smell.

World trade has changed since then. The growth in trade is going to be in the services area. We now have the capacity to make our products in five different countries and assemble them in a sixth. And all of this is made possible by the instant communications of the satellite and by services — accounting, engineering, legal and financial services. It is to me an imperative that the trading system be designed to liberalize trade in the areas that count, and those now include the areas of services and investments.

I know it's a complicated and contentious subject, but at some point in time — in this century, if not in this decade — we have to have a system that really does incorporate a capacity for ongoing negotiation; that does reflect the need to deal with the different types of social and economic structures that nations will by their own desires choose; and that also reflects the obvious need for liberalization in services and investments. If we can do that, then I think we can look forward to a very exciting and productive world economy.

Brookings Council Program on the State of the Union

ON JANUARY 25, 1984, the evening of President Reagan's State of the Union address, the Brookings Council gathered in Washington for an in-depth discussion of the major issues dealt with in the speech. The Council was briefed by top government officials, scholars, and journalists on foreign policy, domestic economic issues, and international trade and fiscal concerns. The Council includes individuals who have provided significant support to Brookings and leaders of the Institution's major corporate sponsors. The Council is chaired by Lloyd N. Cutler of the Brookings Board of Trustees.

The Council's first event outside of Washington, D.C., will be held on May 17th in Los Angeles at The Times-Mirror Company, Inc., the president of which, Robert F. Erburu, is a member of the Brookings board. That meeting will focus on *Economic Choices: 1984*, a major collaborative effort of the Brookings Economic Studies program to be published this spring.



Morris Tanenbaum, executive vice president of American Telephone and Telegraph Co.; James T. Lynn, partner in Jones, Day, Reavis & Pogue and former director of the Office of Management and Budget; William E. Brock, U.S. Trade Representative; and Robert S. Strauss, partner in Akin, Gump, Strauss, Hauer & Feld and former U.S. Trade Representative.



above: William W. Kaufmann of Brookings and the Massachusetts Institute of Technology and Robert S. McNamara, former president of the World Bank.



left: Charles W. Robinson, chairman of the Energy Transition Corporation and former deputy secretary of state, and William T. Coleman, Jr., partner in O'Melveny & Myers and former secretary of transportation.

lower left: Joseph F. Abely, Jr., vice chairman of the board of R. J. Reynolds Industries; Charles W. Parry, chairman of the Aluminum Company of America; and Lloyd N. Cutler, partner in Wilmer, Cutler & Pickering and former counsel to the president.

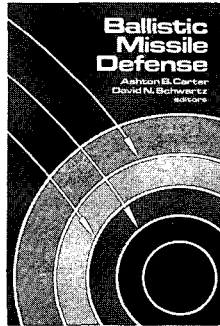
lower right: Charles L. Schultze, senior fellow in the Economic Studies program at Brookings and former chairman of the Council of Economic Advisers, and Peter G. Peterson, chairman of Peterson & Jacobs Co. and former secretary of commerce.



Ballistic Missile Defense: An Objective Analysis—and an Analysis of Objectives

Ballistic Missile Defense

Edited by Ashton B. Carter and
David N. Schwartz
446 pages. \$12.95 paper; \$32.95
cloth.



PRESIDENT REAGAN proposed last March that the United States undertake a massive program of research on technologies — including space-based beam weapons — that might help defend against Soviet missile attacks. The President's proposal, made in what has come to be known as his "Star Wars" speech, seems certain to spark intense debate over the coming year.

Ballistic Missile Defense, a study jointly sponsored by the Brookings Institution and MIT, emphasizes the need to focus that debate on ends as well as means. The volume is co-edited by Ashton B. Carter, a research fellow at MIT's Center for International Studies, and David N. Schwartz, formerly a research associate in the Foreign Policy Studies program at Brookings and now deputy director of the Office of Policy Analysis in the State Department's Bureau of Politico-Military Affairs. As Carter writes in his introduction, "Without a clear statement of the purpose or goal of the defense deployment, it is meaningless to pronounce whether a given BMD (ballistic missile defense) system 'works' or not."

The book is intended to provide policy-makers and the public with a dispassionate analysis of the various issues — strategic, technological, and political — that a new BMD initiative would raise. The volume includes contributions from seventeen experts, each of whom has been directly involved in the shaping of U.S. defense, arms control, or intelligence policy.

Ballistic Missile Defense is intended to inform policy discussions, not to push them toward any particular outcome. The book does point up, however, certain fundamental considerations that enjoy broad consensus among experts and that should be factored into the policy calculus:

- It is highly unlikely — indeed, the prospect is so remote that it is of no practical interest — that BMD will alter the mutual hostage relationship of the U.S. and the Soviet Union, in which each is vulnerable to mortal damage by the other. Therefore, the relevant question for policy-makers is whether less-than-perfect BMD systems, with limited missions (such as defending silos and other military targets or merely adding further uncertainty to Soviet strategic calculations), merit support.

- No military meaningful BMD can be deployed by either superpower under the terms of the Anti-Ballistic Missile Treaty signed in 1972. A deployment in violation of the treaty — or a decision to terminate or seek revision of the agreement — would be seen as a weakening of commitment to arms control in general.

- Since the signing of the ABM Treaty, the Soviet Union has been devoting more effort than the U.S. to research on BMD; there is, according to Sayre Stevens, former CIA deputy director for intelligence, a "significant disparity in the momentum of strategic defensive activities in the two countries." It is clear that if either side were to abrogate the treaty today, the Soviets could put a working BMD system into operation faster than the U.S. could.

- Any calculation of the effectiveness of a BMD must take into account the dynamic nature of offensive capabilities and tactics. Since any significant U.S. BMD deployment would take years to complete, its capability must be measured against the future and potential Soviet nuclear arsenal. Decision-makers need to weigh also the possibility of Soviet countermeasures to sidestep a BMD; Stephen Weiner of the MIT Lincoln Laboratory, in a review of the technical aspects of BMD systems, underscores "the critically important point that BMD is a 'game' played against a hostile opponent rather than an optimization problem in a benign natural environment."

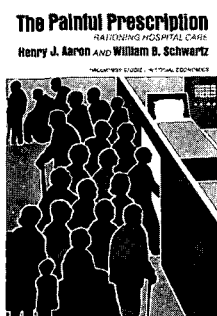
Costs and Constraints: The Rationing of Health Care

The Painful Prescription: Rationing Hospital Care

By Henry J. Aaron

and William B. Schwartz

160 pages. \$8.95 paper; \$22.95 cloth.



EFFECTIVE CONTROL of spiraling U.S. health care costs would require some rationing of care, according to the authors of *The Painful Prescription: Rationing Hospital Care*. "Decisions would have to be made on what services would be made available to whom," write Henry J. Aaron, a senior fellow in the Economics Studies program at Brookings, and William B. Schwartz, a professor of medicine at Tufts University.

Aaron and Schwartz analyze experience with cost containment in Britain — where per capita hospital care expenditures have been held to less than half of the U.S. levels — and, on the basis of that analysis, discuss the likely consequences of a successful U.S. cost containment effort. Their central conclusion is that some benefits would have to be withheld from at least some patients, as they have been in Britain.

The authors report that although some services — such as treatment for hemophiliacs, radiotherapy for cancer, and bone marrow transplantation — are as available in Britain as in the United States, most are not. For example, dialysis for severe chronic kidney failure is performed in Britain at one-tenth the U.S. rate, coronary artery surgery at one-ninth the U.S. rate, and CT scans at one-fifth the U.S. rate.

Aaron and Schwartz predict that many of the patterns evident in Britain would show up in the United States under an effective cost containment regime. American doctors would have to weigh the relative benefits and costs of different forms of care for particular patients — and they would have to decide what care *not* to provide, based on such considerations as the age of the patient. According to the authors, care that is dependent on costly capital equipment would prove relatively easy to ration in the United States, as it has in Britain, because decisions not to acquire such equipment can be made impersonally.

Not all rationing decisions can be made at such a distance from the direct doctor-patient relationship, however. Aaron and Schwartz suggest that U.S. doctors could be expected to seek rationalizations — as British doctors habitually do — to justify denials of care that a lack of resources necessitates. The authors remark that although most British doctors would like to deploy more resources than are now available, "they seem to recognize that their country is not rich enough to provide all the possible benefits of medical care."

Aaron and Schwartz emphasize that the United States would confront special problems in attempting to constrain hospital spending. For instance, because most American doctors are paid on a fee-for-service basis — rather than receiving a set salary as British specialists do — they would be more threatened by cost controls than their British counterparts. Moreover, Aaron and Schwartz write, most U.S. patients have become accustomed to receiving high-quality hospital care without having to wait for admission. Therefore, they would react more sharply to rationing than have the British.

Many Americans and British doctors who have practiced in both countries describe American patients as more aggressive and demanding than British patients. The authors anticipate that Americans would be far more likely to shop among physicians for desired services, to resort to the courts to obtain care (and to bring malpractice suits if denied it), and if all else failed, to try to bring political pressure. They note that the U.S. government is much more susceptible to such pressure than the British parliamentary system, buttressed as it is by party discipline. Notwithstanding these differences, the authors believe that the continuing escalation of hospital costs will create strong pressures in the United States for the rationing of care.

The Advanced Study Program at Brookings: Upcoming Events

The Advanced Study Program has two purposes. The first is to provide continuing education to America's leaders — in business, government, and non-profit organizations — about current issues of domestic and foreign policy, in the expectation that a better understanding of these issues will help people in positions of

responsibility to operate more effectively. The second is to stimulate informal discussions among leaders from different sectors of society, in the hope that the exchange of insights can help to produce wiser public policy.

The "Investment in Leadership" Series: Understanding Federal Government Operations

Dates: May 6 to 11, 1984 May 20 to 25, 1984 June 3 to 8, 1984 June 17 to 22, 1984

Corporate success in the 1980s requires an understanding of the increasingly complex national and international corporate environment. Federal policies — on fiscal and monetary matters, international trade, regulatory issues, and so on — have important impacts on that environment.

Our six-day conferences on the operations of the federal government are designed to give senior executives an intensive overview of Washington policy-making. These informative, off-the-record programs offer three important benefits:

— On-the-spot exposure to "official Washington," including on-site meetings with ad-

ministration representatives, members of Congress, journalists, and other policy experts.

— Examination — from a variety of perspectives — of key policy problems facing the United States today, with an emphasis on the issues of greatest concern to business.

— A unique opportunity to engage in the federal policy process itself, through informal dialogue with Washington decision-makers.

This program is accredited by the American Council on Education for two semester hours of graduate level credit in the field of business-government relations.

The fee for attendance at one of these six-day conferences is \$1,825. This charge covers meals and materials, but not lodging. Advance registration is required. To reserve a space, send payment or billing instructions to:

Registrar, Advanced Study Program
The Brookings Institution
1775 Massachusetts Avenue, N.W.
Washington, D.C. 20036

For further information, call (202)797-6269 or 6272.



1775 MASSACHUSETTS AVENUE N.W. WASHINGTON D.C. 20036

LICENSED TO UNZ.ORG
ELECTRONIC REPRODUCTION PROHIBITED